RECORD AND BRIEFS

17-130

No.

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

RAYMOND J. LUCIA
AND RAYMOND J. LUCIA COMPANIES, INC.,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The District Of Columbia Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether administrative law judges of the Securities and Exchange Commission are Officers of the United States within the meaning of the Appointments Clause.

PARTIES TO THE PROCEEDING AND RULE 29.6 STATEMENT

All parties to the proceeding are named in the caption.

Pursuant to this Court's Rule 29.6, undersigned counsel state that petitioner Raymond J. Lucia Companies, Inc. has no parent corporation, and no publicly held company holds 10 percent or more of its stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners Raymond J. Lucia and Raymond J. Lucia Companies, Inc. respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit.

OPINIONS BELOW

The *per curiam* order of the en banc court of appeals, denying the petition for review by an equally divided court (Pet. App. 1a-2a), is available at 2017 WL 2727019. The panel's opinion (Pet. App. 3a-36a) is reported at 832 F.3d 277. The opinion and order of the Commission (Pet. App. 37a-109a) are available at Exchange Act Release No. 73,857, 2015 WL 5172953; an interim remand order (Pet. App. 238a-243a) is unreported. The relevant initial decision of the administrative law judge (Pet. App. 115a-237a) is available at Initial Decision Release No. 495, 2013 WL 3379719.

JURISDICTION

The judgment of the court of appeals was entered on June 26, 2017. Pet. App. 1a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED

The Appointments Clause as well as pertinent statutory and regulatory provisions are reproduced in the Appendix at 247a-294a.

STATEMENT

Administrative law judges of the Securities and Exchange Commission preside over trial-like adversarial hearings, during which they take testimony, rule on the admissibility of evidence, and enforce compliance with their orders. This Court has ruled that non-Article III adjudicators who exercise such discretionary powers are Officers of the United States who must be appointed pursuant to the Appointments Clause. *Freytag* v. *Comm'r*, 501 U.S. 868, 881-82 (1991). In this case, however, a three-judge panel of the D.C. Circuit ruled that SEC ALJs are mere employees who are not subject to the Appointments Clause. Pet. App. 21a. The Tenth Circuit expressly disagreed with that decision, ruling that SEC ALJs are Officers of the United States within the meaning of the Appointments Clause. *Bandimere* v. *SEC*, 844 F.3d 1168, 1170 (10th Cir. 2016). The D.C. Circuit subsequently granted en banc rehearing, but reached a 5-5 deadlock—leaving the panel decision intact and the circuit split intractable.

1. Long before the advent of the modern administrative state, the Framers understood that curbing abuses of executive power requires carefully cabining the prerogative to *appoint* those who wield it. *Edmond* v. *United States*, 520 U.S. 651, 659-60 (1997). In prescribing the exclusive means of appointing any "Office[r] of the United States," U.S. Const., art. II, § 2, cl. 2, the Appointments Clause "preserves ... the Constitution's structural integrity" by ensuring that officials invested with significant federal authority remain "accountable to political force and the will of the people." *Freytag*, 501 U.S. at 878, 884; *see also Buckley* v. *Valeo*, 424 U.S. 1, 126 (1976) (per curiam).

Congress has charged the SEC with executing and enforcing the federal securities laws, 15 U.S.C. § 78d(a), including the Investment Advisers Act of 1940, *id.* § 80b-9. Congress authorized the Commission to "delegate ... any of its functions" except rulemaking to "administrative law judge[s]." *Id.* § 78d-1(a). When the Commission initiates an enforcement action, it can either sue in federal court or commence an administrative proceeding. *See id.* §§ 78u, 78u-2, 78v. Where the Commission elects to commence an administrative proceeding, an ALJ with delegated authority normally presides over the hearing. *See* 17 C.F.R. § 201.110.

In establishing this statutory scheme, Congress repeatedly referred to SEC ALJs as "officers of the Commission," 15 U.S.C. §§ 77u, 78v, 80a-40, 80b-12; set forth their duties and salary by law, *see* 5 U.S.C. §§ 556-557 (duties), 5372(b) (salary); and prescribed that the "*agency* shall appoint [its] administrative law judges," 5 U.S.C. § 3105 (emphasis added)—a manner of appointment that, if followed, would comport with the Appointments Clause.

The Commission, in turn, has deemed its ALJs "hearing officer[s]" and delegated to those "officer[s] ... the authority to do all things necessary and appropriate to discharge" their duties. 17 C.F.R. § 201.111. That authority is extensive and includes the powers to oversee hearings and discovery, rule on motions (including summary disposition), enter default judgments, and impose or modify sanctions. *See generally ibid.* (non-exhaustive list of ALJs' powers); *see also id.* §§ 201.155 (default), .180 (sanctions), .230 (document production), .232-.234 (subpoenas and depositions), .250 (summary disposition), .320-.326 (evidence). SEC ALJs also rule on the admissibility of evidence,

take testimony, and make credibility findings, to which the Commission defers absent overwhelming evidence to the contrary. Pet. App. 19a. The Commission acknowledged in this case that ALJ fact-finding plays a "vital role" in the agency's decision-making process. *Id.* 241a.

At the conclusion of an administrative hearing, SEC ALJs enter an "initial decision," 17 C.F.R. § 201.360(a)(1), that can and almost always does "become final," *id.* § 201.360(d)(2). Although the Commission "retain[s] a discretionary right to review" any "action" by an ALJ, whether *sua sponte* or upon a petition for review, 15 U.S.C. § 78d-1(b), "[i]f the right to exercise such review is declined" or not timely sought, the ALJ's action is "deemed the action of the Commission," *id.* § 78d-1(c). About 90 percent of ALJ decisions are *not* reviewed by the Commission, *see Bandimere*, 844 F.3d at 1180 n.25; in such cases, the Commission "will issue an order that the decision has become final," 17 C.F.R. § 201.360(d)(2).

It is undisputed that, if SEC ALJs are constitutional Officers, then the current procedure for their selection does not comply with the Appointments Clause. Pet. App. 9a-10a. SEC ALJs are not appointed by the Commission as a whole, but rather selected by SEC staff from a pool of candidates identified by the Office of Personnel Management. *Id.* 295a-297a (providing details of how SEC ALJs are selected).

2. Petitioner Raymond J. Lucia, formerly the sole owner of petitioner Raymond J. Lucia Companies, Inc., is an investment professional who—until this proceeding—had an unblemished record spanning nearly forty years. *See* Pet. App. 34a; 119a-120a; 233a. In free seminars for potential clients (at which

no securities were offered or sold), he promoted a retirement strategy colorfully named "Buckets of Money," which advocated a diversified portfolio from which, in retirement, investors would liquidate lower-risk investments first to give riskier investments time to grow. *Id.* 23a; 127a-129a.

Mr. Lucia used a slideshow that compared fictional investors following his strategy with investors following other strategies in hypothetical scenarios. Pet. App. 23a; 130a-132a. Two examples, which the slides described as "backtests," were based partly on historical data, such as stock returns, and partly on assumptions for other variables, such as inflation and real-estate rates of return. Both Mr. Lucia (orally) and the slides (in writing) repeatedly disclosed this use of assumptions, and the slides included dozens of disclaimers that the examples were "hypothetical." *Id.* 24a-29a; 43a n.10; 45a n.14; 76a-77a. Before Mr. Lucia publicly distributed the slideshow, supervising broker-dealers repeatedly approved the slides, and Commission staff had reviewed a similar version—and none had raised any concern that the slides were misleading. *See id.* 84a.

3. In 2012, the Commission charged petitioners with violating the anti-fraud provisions of the Investment Advisers Act of 1940 and SEC rules. Pet. App. 7a-8a. After the Commission elected to proceed administratively rather than in federal court, ALJ Cameron Elliot presided over a trial-like hearing at which witnesses testified and were cross-examined, documents were introduced into evidence, and objections were made and ruled upon. After Judge Elliot issued an initial decision, the Commission remanded for further factual findings, *id.* 239a, because they

were "a matter of considerable importance" to the Commission, *id.* 241a.

On remand, Judge Elliot found that Mr. Lucia's presentations were misleading because they used the word "backtest"—a term with no statutory or regulatory definition—to describe hypotheticals that were not based solely on historical data, but included certain disclosed assumptions. Pet. App. 115a-116a; 196a-197a. Despite finding that the SEC had not proved any investor losses, Judge Elliot barred Mr. Lucia from working as an investment advisor for the rest of his life, revoked his company's registration, and assessed civil penalties. *Id.* 225a-233a. Because of these sanctions, Mr. Lucia is unemployable in his lifelong profession and on the verge of bankruptcy.

4. Petitioners timely sought Commission review, challenging the initial decision on the merits and arguing that Judge Elliot held office in violation of the Appointments Clause. Pet. App. 38a-40a. The Commission granted discretionary review and—by a 3-2 vote—affirmed in relevant part. *Ibid.*; *id.* 110a.

On the merits, the Commission majority sustained Judge Elliot's finding that the presentations were misleading because a "backtest" must use "historical data" whereas petitioners' hypotheticals relied in part on assumptions. Pet. App. 66a-69a. Relying on *Landry* v. *FDIC*, 204 F.3d 1125 (D.C. Cir. 2000), the Commission majority further concluded that SEC ALJs are "not subject to the requirements of the Appointments Clause," Pet. App. 86a, because "it is 'the Commission's issuance of a finality order' that makes [an ALJ's] decision effective and final," *id.* 90a.

In the SEC's only written dissent of 2015, Commissioners Gallagher and Piwowar sharply disagreed

on the merits. *See* Pet. App. 110a-114a. The dissenters explained that the majority had "create[d] from whole cloth specific requirements for advertisements that include the word 'backtest,'" and then applied to petitioners a new rule deeming it misleading "if a backtest fails to use actual historical rates—even if the slideshow presentation specifically discloses the use of assumed rates for certain components." *Id.* 111a. The dissenters also noted that Article III courts should decide the Appointments Clause issue. *Id.* 113a.

5. A three-judge panel of the D.C. Circuit denied a timely petition for review. Pet. App. 4a. In addition to sustaining the Commission's decision on the merits, *id.* 21a-36a, the panel rejected petitioners' Appointments Clause challenge.

The panel stated that, under the D.C. Circuit's 2-1 decision in *Landry*, the constitutional "analysis begins, and ends," with "whether Commission ALJs issue final decisions of the Commission." Pet. App. 13a. Petitioners argued both that *Landry*'s approach was inconsistent with *Freytag*, which rejected the argument that adjudicators "may be deemed employees ... because they lack authority to enter a final decision," 501 U.S. at 881, and that applying *Landry* here would be inconsistent with *Edmond*'s holding that certain military appellate judges were Officers even though their decisions were subject to discretionary review. *See* Pet. App. 13a. But the panel summarily responded that "this court has rejected that argument, and *Landry* is the law of the circuit." *Ibid.*

Relying solely on *Landry*, the panel held that SEC ALJs are not Officers because their decisions are subject to discretionary Commission review and, therefore, are not independently final. Pet. App. 13a-18a.

The panel concluded that "the Commission has retained full decision-making powers" in every case because an ALJ's "initial decision becomes final when, and only when, the Commission issues [a] finality order." *Id.* 15a.

Petitioners timely filed a petition for rehearing en banc, arguing that the panel decision could not be reconciled with this Court's Appointments Clause jurisprudence. Petitioners also pointed out that, in opposing certiorari in *Landry*, the government had defended *Landry* as limited to one particular agency, *see* Br. in Opp. 7, *Landry* v. *FDIC*, No. 99-1916 (U.S. Aug. 28, 2000), 2000 WL 34013905 ("*Landry* BIO"), but reneged on that promise in this case by arguing that *Landry* resolved the Appointments Clause question for all ALJs.

While that petition was pending, the Tenth Circuit ruled that SEC ALJs *are* Officers of the United States who must be appointed pursuant to the Appointments Clause. *Bandimere*, 844 F.3d at 1179, 1188. The Tenth Circuit majority expressly disagreed with the D.C. Circuit's reasoning: "*Landry* place[s] undue weight on final decision-making authority." *Id.* at 1182. As Judge Briscoe explained, "[t]he critical difference between the [*Bandimere*] majority and *Landry* and *Lucia* is that the majority recognizes that *Freytag* does *not* make final decision-making authority the *sine qua non* of inferior Officer status." *Id.* at 1189 (concurring opinion). The government filed a petition for rehearing that was "transmitted to all the judges of the court who are in regular active service" and then, after Justice Gorsuch's confirmation, denied by a 9-2 vote. *Bandimere* v. *SEC*, 855 F.3d 1128 (10th Cir. 2017).

In light of these conflicting decisions, the D.C. Circuit granted rehearing en banc to resolve two questions: (1) "Is [Judge Elliot] an inferior officer rather than an employee for the purposes of the Appointments Clause of Article II of the Constitution?"; and (2) "Should the court overrule [*Landry*]?" Pet. App. 245a. Under the D.C. Circuit's rules, a grant of en banc rehearing vacates the panel's judgment but "ordinarily not its opinion." D.C. Cir. R. 35(d).

The ten judges comprising the en banc court heard argument on May 24, 2017. *Hear* Oral Argument, *Raymond J. Lucia Cos., Inc.* v. *SEC*, 2017 WL 2727019 (D.C. Cir. June 26, 2017) (en banc) (No. 15-1345), https://tinyurl.com/yddcpeyh (all Internet sites last visited July 17, 2017). A month later, the court issued a brief *per curiam* order and judgment stating that the petition for review was denied by an equally divided court. Pet. App. 1a-2a (citing D.C. Cir. R. 35(d)).

REASONS FOR GRANTING THE PETITION

The D.C. Circuit—which hears more petitions for review of SEC action than any other court of appeals—granted en banc rehearing to decide whether SEC ALJs are constitutional Officers, and then deadlocked 5-5 on that question, confirming that this Court's review is required. *Cf. Alice Corp. Pty., Ltd.* v. *CLS Bank Int'l*, 134 S. Ct. 2347, 2353-54 (2014) (granting review after en banc court of appeals failed to produce majority opinion resolving recurring issue). Moreover, the en banc court's inability to resolve the Appointments Clause issue leaves in place a square and acknowledged conflict between the panel decision in this case, which held that SEC ALJs are mere employees, and the Tenth Circuit's contrary holding that SEC ALJs are Officers of the United States. *Compare*

Pet. App. 21a *with Bandimere* v. *SEC*, 844 F.3d 1168, 1188 (10th Cir. 2016). Only this Court can resolve this conflict. This case cleanly presents the important and recurring question whether SEC ALJs are Officers who must be appointed pursuant to the Appointments Clause.

I. SEC ALJs Are Officers Of The United States

This Court's precedents make clear that the Appointments Clause's purposefully broad category of "Officers" includes SEC ALJs because they exercise significant discretion in conducting trials, making evidentiary and other rulings that shape the administrative record, and issuing initial decisions that become final in 90 percent of cases.

A.1. This Court has consistently applied a simple, expansive definition of "Officer": Every official whose position is "established by Law" and who exercises "significant authority pursuant to the laws of the United States is an 'Officer of the United States.'" *Buckley* v. *Valeo*, 424 U.S. 1, 126, 132 (1976) (per curiam) (quoting U.S. Const. art. II, § 2, cl. 2). "Unless their selection is elsewhere provided for" in the Constitution—as with the President—"*all* officers of the United States" who meet these criteria "are to be appointed in accordance with the Clause." *Id.* at 132.

Buckley's broad definition of "Officer" makes perfect sense of the Clause's text. *See, e.g.*, 2 Samuel Johnson, *A Dictionary of the English Language*, s.v. "officer" (6th ed. 1785) ("A man employed by the publick"); 2 Noah Webster, *An American Dictionary of the English Language*, s.v. "officer" (1828) (similar). And it is pivotal to the "structural safeguar[d]" the text provides. *Edmond* v. *United States*, 520 U.S. 651, 659

(1997). The Framers viewed "'the power of appointment to offices'" as "'the most insidious and powerful weapon of eighteenth century despotism.'" *Freytag* v. *Comm'r*, 501 U.S. 868, 883 (1991) (citation omitted). They "understood ... that by limiting the appointment power" to those who were readily identifiable, "they could ensure that those who wielded it were accountable to political force and the will of the people." *Id.* at 884. The Clause's restrictions thus "preserv[e] ... the Constitution's structural integrity by preventing the diffusion of the appointment power." *Id.* at 878.

The Court's modern definition of "Officer" reflects two centuries of decisions holding a wide range of officials to be subject to the Clause—including:

- district-court clerks, *Ex parte Hennen*, 38 U.S. (13 Pet.) 230, 258 (1839);
- a clerk to an assistant treasurer in Boston, *United States* v. *Hartwell*, 73 U.S. (6 Wall.) 385, 393-94 (1868);
- engineers and assistant surgeons, *United States* v. *Perkins*, 116 U.S. 483, 484 (1886); *United States* v. *Moore*, 95 U.S. 760, 762 (1878);
- "thousands of clerks in the Departments of the Treasury, Interior and the othe[r]" departments, *United States* v. *Germaine*, 99 U.S. 508, 511 (1879), responsible for "the records, books, and papers appertaining to the office," *Hennen*, 38 U.S. (13 Pet.) at 259;
- judges of election and federal marshals, *Ex parte Siebold*, 100 U.S. 371, 397-99 (1880);
- "commissioners of the circuit courts" who "t[ook] ... bail for the appearance of persons

charged with crime," *United States* v. *Allred*, 155 U.S. 591, 594 (1895);

- extradition commissioners, *Rice* v. *Ames*, 180 U.S. 371, 378 (1901);
- district-court commissioners, *Go-Bart Importing Co.* v. *United States*, 282 U.S. 344, 352-54 (1931); and
- U.S. attorneys, *Myers* v. *United States*, 272 U.S. 52, 159 (1926).

Only individuals with "no general functions, nor any employment which has any duration as to time," whose posts lack "tenure, duration, continuing emolument, or continuous duties," and who "ac[t] only occasionally and temporarily" have been held by this Court to fall outside the Clause. *Auffmordt* v. *Hedden*, 137 U.S. 310, 327 (1890); *see also Buckley*, 424 U.S. at 126 n.162 (employees are "lesser functionaries subordinate to" Officers).

2. This Court has *never* held that a federal adjudicator is a mere employee, while holding that many quasi-judicial officials—including clerks, commissioners, and non-Article III judges—*are* Officers. *See generally* Jennifer L. Mascott, *Who Are 'Officers of the United States'?*, 70 Stan. L. Rev. (forthcoming 2017) (draft at https://tinyurl.com/zewj8z2); Kent Barnett, *Resolving the ALJ Quandary*, 66 Vand. L. Rev. 797, 799-803, 810-14 (2013). For example, court commissioners (the predecessors of today's magistrate judges) are constitutional Officers. *Go-Bart*, 282 U.S. at 352-54; *Allred*, 155 U.S. at 594. There is no difference of constitutional magnitude between magistrate judges and administrative law judges.

The critical decision is *Freytag*, in which this Court held that special trial judges of the U.S. Tax

Court are Officers. 501 U.S. at 880-82. Although STJs could make final decisions in some cases, in other cases (including *Freytag* itself) they lacked final decision-making power and could issue only proposed opinions, which the Tax Court was free to accept or reject. *Ibid.* *Freytag* unanimously held that, even in such cases, STJs acted as Officers because they "exercised significant discretion" in performing "important functions"—specifically, "tak[ing] testimony," "conduct[ing] trials," "rul[ing] on the admissibility of evidence," and "enforc[ing] compliance with discovery orders." *Id.* at 881-82; *accord id.* at 901 (Scalia, J., concurring in part and concurring in the judgment).

This Court has held that military judges, too, are Officers based on their significant adjudicatory duties. In *Weiss* v. *United States*, 510 U.S. 163 (1994), the Court explained that military judges are Officers "because of the authority and responsibilities [they] possess," which include ruling on procedural and legal issues and adjudicating offenses under the Uniform Code of Military Justice. *Id.* at 167-69; *see also Ryder* v. *United States*, 515 U.S. 177, 180-88 (1995). This Court's decision in *Edmond* likewise recognized that intermediate appellate military judges are Officers, in part because they "independently 'weigh the evidence, judge the credibility of witnesses, and determine controverted questions of fact.'" 520 U.S. at 662 (quoting 10 U.S.C. § 866(c)). That the judges "ha[d] no power to render a final decision" on their own was relevant only to whether they were "inferior officers" or "principal officers." *Id.* at 665-66.

B. Under these principles and precedents, SEC ALJs are "Officers" subject to the Appointments Clause. It is not disputed that SEC ALJs hold offices established by law, or that they exercise authority—

including ruling on the admissibility of evidence, taking testimony, and conducting trials—previously deemed sufficiently "significant" to confer Officer status. *Freytag*, 501 U.S. at 881-82. This Court need go no further to conclude that SEC ALJs are Officers.

Like the special trial judges in *Freytag*, SEC ALJs' "duties, salary, and means of appointment" all "are specified by statute," 501 U.S. at 881; *see* 5 U.S.C. §§ 556-557, 3105, 5372. Congress in fact *referred* to SEC ALJs as "officers" in the securities laws. 15 U.S.C. § 77u ("[a]ll hearings ... may be held before the Commission or an *officer* or *officers* of the Commission designated by it" (emphases added)); *see id.* §§ 78v, 80a-40, 80b-12 (same). Federal law accordingly provides that the "*agency*"—here, the Commission—"shall appoint ... administrative law judges." 5 U.S.C. § 3105 (emphasis added); *see Free Enter. Fund* v. *PCAOB*, 561 U.S. 477, 512-13 (2010) (SEC Commissioners acting as a body constitute a "Head of Department" under the Clause). The SEC has never explained why the Commission itself does not—or could not—appoint its ALJs.

SEC ALJs also "'exercis[e] significant authority pursuant to the laws of the United States,'" *Freytag*, 501 U.S. at 881 (quoting *Buckley*, 424 U.S. at 126), entrusted to them by the federal securities laws and the Commission. That authority includes the power to "conduc[t] hearings in proceedings instituted by the Commission," and "to do all things necessary and appropriate to discharge" that function. 17 C.F.R. § 200.14. Specific duties include:

- amending charging documents, *id.* § 201.200(d)(2);
- entering orders of default, *id.* § 201.155;

- consolidating proceedings, *id.* § 201.201(a);
- "[a]dminister[ing] oaths and affirmations," *id.* §§ 200.14(a)(1), 201.111(a);
- "[i]ssu[ing] subpoenas," *id.* §§ 200.14(a)(2), 201.111(b);
- ordering depositions and acting as the "deposition officer," *id.* §§ 201.233-.234;
- ordering production of evidence and regulating document production, *id.* §§ 201.111(b), .230, .232;
- issuing protective orders, *id.* § 201.322;
- "[r]ul[ing] upon motions," including for summary disposition, *id.* §§ 200.14(a)(7), 201.111(h), .250;
- rejecting filings for procedural noncompliance, *id.* § 201.180(b);
- granting extensions of time and stays, *id.* § 201.161;
- "[h]old[ing] pre-hearing conferences" and "requir[ing]" attendance at such conferences, *id.* §§ 200.14(a)(6), 201.111(e), .221(b);
- ordering prehearing submissions, *id.* § 201.222(a);
- "[r]egulat[ing] the course of [the] hearing," *id.* §§ 200.14(a)(5), 201.111(d);
- receiving "relevant evidence" and ruling upon admissibility, *id.* § 201.111(c);
- "[r]ul[ing] on offers of proof," *id.* §§ 200.14(a)(3), 201.111(c);
- "[e]xamin[ing] witnesses," *id.* § 200.14(a)(4);

- regulating the scope of cross-examination, *id.* § 201.326;
- regulating "the conduct of the parties and their counsel," *id.* § 201.111(d); and
- imposing sanctions for "contemptuous conduct," *id.* § 201.180(a).

These are *adjudicatory* functions that, under *Freytag*, reflect Officer status. *Bandimere*, 844 F.3d at 1187 ("STJs and ALJs closely resemble one another where it counts"). To be sure, ALJs cannot impose fines or imprisonment for contempt (although they can impose other sanctions against contumacious litigants or attorneys), but that is true of most administrative agency officials. *See ICC* v. *Brimson*, 154 U.S. 447, 488-89 (1894). Indeed, the statute that grants the Tax Court contempt power, 26 U.S.C. § 7456(c), does not grant STJs the same power. And this Court has never hinted that contempt power is even relevant to Officer status.

In addition to performing the same functions found significant in *Freytag* (and then some), the SEC ALJ, following a hearing, "prepare[s] an initial decision containing the conclusions as to the factual and legal issues presented." 17 C.F.R. §§ 200.14(a)(8), 201.111(i), .141(b), .360(a). Although parties may petition for review of the ALJ's initial decision by the Commission, or the Commission may review the decision *sua sponte*, *see id.* § 201.410(a), review of an ALJ decision is the exception: In approximately 90 percent of cases, no such further review is conducted. *See Bandimere*, 844 F.3d at 1180 n.25; SEC, ALJ Initial Decisions, https://www.sec.gov/alj/aljdec.shtml. Review often is not sought, and even when requested it is not always granted. *See* 17 C.F.R. § 201.411(b)(2)

(the Commission can "decline to review any [ALJ] decision," except in limited circumstances not pertinent here); *see also, e.g.*, *In re Bellows*, Exchange Act Release No. 40,411, 1998 WL 611766 (Sept. 8, 1998) (declining such review). SEC ALJs also have power to issue default orders that are immediately judicially "enforceable" without *any* SEC review. *In re Alchemy Ventures, Inc.*, Exchange Act Release No. 70,708, 2013 WL 6173809, at *4 (Oct. 17, 2013).

If no timely petition for review is filed or if the Commission declines review, the ALJ's initial decision by statute "shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission." 15 U.S.C. § 78d-1(c); *accord* 5 U.S.C. § 557(b) (ALJs' "initial decisions" automatically become final "without further proceedings" absent further review). In such cases, the Commission's regulations provide that it "will issue an order that the [ALJ's] decision has become final." 17 C.F.R. §§ 201.360(a)(1), .360(d)(2). The finality order is non-discretionary and issues as a matter of course after 42 days when no petition for review has been filed. *See id.* §§ 201.360(d)(2), .410(b), .411(c).

On the relatively rare occasions the Commission *does* review an ALJ's initial decision, the Commission does not review the decision anew, but defers to the ALJ's credibility determinations and factual findings. *See In re Clawson*, Exchange Act Release No. 48,143, 2003 WL 21539920, at *2 (July 9, 2003) ("We accept [an SEC ALJ's] credibility finding, absent *overwhelming evidence* to the contrary" (emphasis added)); *In re Bridge*, Securities Act Release No. 9,068, 2009 WL 3100582, at *18 n.75 (Sept. 29, 2009) (similar). As the Commission emphasized in this case, SEC ALJs play a "vital role" in the adjudicative process, as they are

"'in the best position to make findings of fact ... and resolve any conflicts in the evidence.'" Pet. App. 241a (citation omitted). Judge Elliot is the only adjudicator in this case who saw and heard the witnesses testify, who reviewed all the evidence, and who shaped the record through evidentiary and other rulings. *See, e.g., id.* 193a (finding an Enforcement Division witness credible after noting that evidence concerning a false claim brought by that witness had previously been excluded).

The authority of SEC ALJs mirrors that of the STJs in *Freytag* (as well as the military judges in *Weiss* and *Edmond*). Indeed, the SEC itself represents to the public that its ALJs perform comparable functions to *federal district judges*. SEC, Office of Administrative Law Judges, https://www.sec.gov/alj (last modified Jan. 26, 2017) (ALJs "conduct public hearings ... in a manner similar to non-jury trials in the federal district courts"); *see also* SEC, SEC Announces Arrival of New Administrative Law Judge Cameron Elliot, http://www.sec.gov/news/press/2011/2011-96.htm (Apr. 25, 2011). This Court has similarly observed that "the role of the modern ... administrative law judge ... is 'functionally comparable' to that of a judge." *Butz* v. *Economou*, 438 U.S. 478, 513 (1978). A number of Justices, in fact, have previously indicated that ALJs in general are Officers. *See Free Enter. Fund*, 561 U.S. at 542 (Breyer, J., joined by Stevens, Ginsburg, and Sotomayor, JJ., dissenting); *Freytag*, 501 U.S. at 910 (Scalia, J., joined by O'Connor, Kennedy, and Souter, JJ., concurring in part and concurring in the judgment).

Until recently, the Executive Branch agreed that officials with the authority of ALJs are Officers. The Office of Legal Counsel—responsible for providing

"authoritative legal advice" for the Executive Branch (DOJ, Office of Legal Counsel, http://www.justice.gov/olc)—opined that an "'Office[r] of the United States'" is one who "possesses delegated sovereign authority to act in the first instance, *whether or not that act may be subject to direction or review by superior officers*." *Officers of the U.S. Within the Meaning of the Appointments Clause*, 31 Op. O.L.C. 73, 95 (2007) (emphasis added). That opinion has never been withdrawn or disavowed by the President or the Attorney General, and it is flatly contrary to the D.C. Circuit's finality requirement and the SEC's litigating position in this case. It makes clear that "[n]either *Buckley* nor early authority supports [a] restriction" of Officer status to exclude those who "'act only at the direction of'" other Officers. *Id.* at 93 (citation omitted).

Under this Court's established (and unbroken) line of Appointments Clause jurisprudence, SEC ALJs are Officers of the United States within the meaning of the Clause.

II. THERE IS A DIRECT AND ACKNOWLEDGED CIRCUIT SPLIT ON THE QUESTION PRESENTED

Two courts of appeals have now applied this body of precedent to reach conflicting decisions on whether SEC ALJs are Officers of the United States who must be appointed pursuant to the Appointments Clause. The D.C. Circuit panel answered that question in the negative, while the Tenth Circuit answered it in the affirmative. The question presented is binary; one of these two decisions *must* be wrong. Indeed, at each step in the analysis the Tenth Circuit squarely "disagree[d]" with the panel decision left in place by the en banc court's order. *Bandimere*, 844 F.3d at 1182. Moreover, the judgment in this case denying the peti-

tion for review is irreconcilable with the Tenth Circuit's judgment granting a petition for review based on the identical constitutional challenge. *Compare* Pet. App. 2a *with Bandimere*, 844 F.3d at 1188. Certiorari is necessary to resolve this dispute between the circuits on an important and recurring constitutional issue.

A. The D.C. Circuit Wrongly Concluded That SEC ALJs Are Mere Employees

The panel decision never addressed the many important, and discretionary, duties exercised by SEC ALJs discussed above. Instead, it held that under *Landry* its "analysis begins, and ends," with whether SEC ALJs can issue unreviewable final decisions of the Commission, and concluded that they cannot. Pet. App. 13a; *see also Bandimere*, 844 F.3d at 1182 ("The D.C. Circuit followed *Landry*" and "considered dispositive" SEC ALJs' supposed "inability to render final decisions"). Confining the Appointments Clause's reach to those who have the power of final decision, however, contravenes this Court's teaching in *Freytag*. At minimum, confining the Clause's reach to those who can issue *unreviewable* final decisions cannot be reconciled with this Court's teaching in *Edmond*.

1. The panel decision uncritically adopted its finality requirement from the D.C. Circuit's divided decision in *Landry*, Pet. App. 13a, which held that inferior Officers must have the "power of final decision," 204 F.3d at 1134. *This* Court's precedents make clear, though, that authority to issue final decisions is a criterion that distinguishes inferior Officers from principal Officers, not a *sine qua non* for the Clause to apply at all.

Freytag expressly rejected the argument that inability to make final decisions takes officials outside the Appointments Clause. 501 U.S. at 880-82. In many cases, including *Freytag* itself, STJs "lack[ed] authority to enter a final decision," and merely "assist[ed]" other officials "in taking the evidence and preparing the proposed findings and opinion." *Ibid.* That did not matter, *Freytag* held, and deeming those judges mere employees on that basis would "ignor[e] the significance of the duties and discretion that [the] judges possess"—namely, the fact that they "perform[ed] more than ministerial tasks," including "tak[ing] testimony," "conduct[ing] trials," and "rul[ing] on the admissibility of evidence." *Ibid.*

To be sure, the *Freytag* Court went on to hold in the alternative that "*[e]ven if* the duties of special trial judges ... were not as significant as we ... have found them to be, our conclusion would be unchanged" because STJs could issue final decisions in *other* cases. 501 U.S. at 882 (emphasis added). But as Judge Randolph cogently explained, that "conclusion" was "[t]he conclusion" the Court "had reached in the preceding paragraphs"—"namely, that although special trial judges may not render final decisions, they are nevertheless inferior officers of the United States." *Landry*, 204 F.3d at 1142 (concurring opinion); *see Freytag*, 501 U.S. at 881. The power of final decision in *Freytag* is thus "clearly designated ... as an alternative holding." *Landry*, 204 F.3d at 1142 (Randolph, J., concurring). While authority to make final decisions may be *sufficient* to trigger the Appointments Clause, the Appointments Clause hardly makes such authority *necessary*—and under this Court's precedent it is not.

The panel in this case summarily rejected petitioners' argument that *Landry*'s contrary reasoning

was "inconsistent with *Freytag*," stating that "*Landry* is the law of the circuit." Pet. App. 13a. But *Landry* was wrongly decided, as Judge Randolph pointed out at the time. *See* 204 F.3d at 1140-43 (concurring opinion). Time and again, this Court has held that adjudicators who lacked final decision-making authority nevertheless were constitutional Officers. *See, e.g.*, *Go-Bart*, 282 U.S. at 352, 354 ("All the [Officer's] acts ... were preparatory and preliminary to a consideration of the charge by a grand jury and ... the final disposition of the case in the district court"); *Allred*, 155 U.S. at 595 (commissioners are "subject to the orders and directions of the court appointing them"); *accord Weiss*, 510 U.S. at 168 ("No sentence imposed [by the Officer] becomes final until it is approved by the officer who convened the court-martial"). Since these officials all are Officers notwithstanding their lack of final decision-making authority, such authority *cannot* be the lynchpin of Officer status as the court below made it.

2. The panel decision not only erroneously confined the Appointments Clause to officials with final decision-making authority, but also implausibly extended that requirement to exempt officials who *can and do* issue final decisions, so long as those decisions are subject to "'discretionary ... review.'" Pet. App. 14a-18a. That holding cannot be reconciled with this Court's decision in *Edmond*.

Edmond held that judges on the Coast Guard Court of Criminal Appeals were inferior Officers because their decisions were always subject to further review by principal Officers—namely, the Court of Appeals for the Armed Forces—whether by *sua sponte* order of the Judge Advocate General or where the CAAF exercised its discretion to grant review.

520 U.S. at 664-65; *see* 10 U.S.C. § 867(a). The lack of "power to render a final decision ... unless permitted to do so by other Executive officers," *Edmond* held, is the defining *feature* of "'inferior officers,'" distinguishing them from the "'principal officer[s]'" that supervise them. 520 U.S. at 663, 665; *see also Dep't of Transp.* v. *Ass'n of Am. R.Rs.*, 135 S. Ct. 1225, 1239 (2015) (Alito, J., concurring) ("Inferior officers can do many things, but nothing final should appear in the Federal Register unless a Presidential appointee has at least signed off on it").

As the United States has represented to this Court on at least two occasions, "*Edmond* makes clear [that] ... inability to render a *final* decision" is "indicative of inferior ... officer status." U.S. Br. 32 n.10, *Free Enter. Fund* v. *PCAOB*, No. 08-861 (U.S. Oct. 13, 2009), 2009 WL 3290435 (emphasis omitted); *see also Landry* BIO 12 n.4 ("In concluding that judges on the Coast Guard Court of Criminal Appeals are 'inferior' rather than 'principal' officers, the Court in *Edmond* observed that those judges 'have no power to render a final decision on behalf of the United States *unless permitted to do so by other Executive officers*'").

The panel nevertheless held that SEC ALJs are employees, not Officers, precisely because their decisions are subject to discretionary review. That holding cannot be squared with *Edmond* or, indeed, any other decision where this Court held that an official who cannot render an unreviewable final decision of the Executive Branch is nevertheless an Officer:

Case	Adjudicator	Officer?	Unreviewable Final Decisions?
Go-Bart, 282 U.S. 344	U.S. Commissioners	**Yes.** 282 U.S. at 352.	**No.** 282 U.S. at 354.
Allred, 155 U.S. 591	U.S. Circuit Commissioners	**Yes.** 155 U.S. at 594-95.	**No.** 155 U.S. at 595.
Weiss, 510 U.S. 163	Military judges	**Yes.** 510 U.S. at 169.	**No.** 510 U.S. at 168.
Ryder, 515 U.S. 177	Judges of the Coast Guard Court of Military Review	**Yes.** 515 U.S. at 180-88.	**No.** *Edmond*, 520 U.S. at 653, 665.
Edmond, 520 U.S. 651	Judges of the Coast Guard Court of Criminal Appeals	**Yes.** 520 U.S. at 662-66.	**No.** 520 U.S. at 665.
Free Enter. Fund, 561 U.S. 477	Public Company Accounting Oversight Board	**Yes.** 561 U.S. at 486.	**No.** 537 F.3d at 673.

Even federal *magistrates*—who wield wide authority and plainly are Officers under *Buckley*—would not be Officers under the D.C. Circuit's test because they cannot (absent consent) render final decisions on the merits. *See* 28 U.S.C. § 636(b)(1)(A).

In short, the D.C. Circuit's finality rule conflates a prerequisite for principal-Officer status with a gateway requirement for the Appointments Clause to apply at all. As *Edmond* explained, the very term "'inferior officer' connotes a relationship with some higher ranking officer"; their "work is directed and supervised" by such "'principal officer[s].'" 520 U.S. at 662-63; *see also NLRB* v. *SW Gen., Inc.*, 137 S. Ct. 929, 947 (2017) (Thomas, J., concurring) ("a principal officer is one who has no superior other than the President"). The Appointments Clause by its terms covers *both* types of Officers, simply allowing (at Congress's option) a different appointment method for the latter. U.S. Const. art. II, § 2, cl. 2. The D.C. Circuit's finality rule, however, effectively confines the Clause to *only* principal Officers, *i.e.*, those with power to make unreviewable final decisions. If the decision below were allowed to stand, it would erase the category of "inferior Officers" from the text of our Constitution.

3. The panel decision noted that Congress "provid[ed] Civil Service protections to ALJs in response to concerns their actions were influenced by a desire to curry favor with agency heads." Pet. App. 21a (citing *Ramspeck* v. *Fed. Trial Exam'rs Conference*, 345 U.S. 128, 132 & n.3, 142 (1953)). The effectiveness of this structure might be questioned given that in roughly 50 decisions before this one, Judge Elliot had not once ruled against the Commission. *See* Sarah N. Lynch, *SEC Judge Who Took on the "Big Four" Known for Bold Moves*, Reuters (Feb. 3, 2014), https://tinyurl.com/hlu76fl. To be sure, the Commission exercised its power of discretionary review and (by a 3-2 margin) affirmed his decision; but that establishes only that Judge Elliot is an inferior rather than a principal Officer. *See Edmond*, 520 U.S. at 665.

In any event, individuals with civil service protections may be Officers. *See, e.g., Cw. of Pennsylvania* v. *U.S. Dep't of HHS*, 80 F.3d 796, 801-04, 806 (3d Cir. 1996). Indeed, contemporaneously with *Ramspeck* the Attorney General opined that hearing examiners—the predecessors to ALJs—were "inferior officers" even though their pay, promotion, and termination were controlled by the Civil Service Commission. *Administrative Procedure Act, Promotion of Hearing Examiners*, 41 Op. Att'y Gen. 74, 79-80 (1951).

As *Ramspeck* explained, "Congress intended to make hearing examiners 'a special class of semi-independent subordinate hearing *officers*.'" 345 U.S. at 132 (emphasis added) (citation omitted). When Congress originally enacted the Administrative Procedure Act of 1946, it thus referred to hearing examiners as "officers" *nine* times. *See* Administrative Procedure Act, Pub. L. No. 79-404, 60 Stat. 237 (1946). And in enacting the securities laws, Congress referred to ALJs as "officers," prescribing that "[a]ll hearings ... may be held before the Commission or an *officer* or *officers* of the Commission." 15 U.S.C. § 77u (emphases added); *see also id.* §§ 78v, 80a-40, 80b-12 (same).

The panel here said that "there is no indication Congress intended these officers to be synonymous with 'Officers of the United States' under the Appointments Clause." Pet. App. 21a. But this Court has squarely rejected this very argument. *Germaine*, 99 U.S. at 510 (if Congress's use of "officers" had meant "others than officers as defined by the Constitution, words to that effect would be used, as servant, agent, person in the service or employment of the government"). The panel's decision runs headlong into this precedent and the rest of this Court's Appointments Clause jurisprudence.

B. The Tenth Circuit Correctly Held That SEC ALJs Are Officers

The Tenth Circuit has held—on materially indistinguishable facts—that "SEC ALJs are inferior officers who must be appointed in conformity with the Appointments Clause." *Bandimere*, 844 F.3d at 1181. The result in *Bandimere* shows that there is a conflict among the circuits that requires this Court's intervention; its reasoning points up the errors made by the panel in this case.

1. *Bandimere*, like this case, concerned an SEC administrative action resulting in a lifetime industry bar and civil penalties. 844 F.3d at 1171. In affirming the ALJ's initial decision on discretionary review, *ibid.*, the Commission again relied on the D.C. Circuit's decision in *Landry* and concluded that SEC ALJs are not "Officers" within the meaning of the Appointments Clause. *In re Bandimere*, Securities Act Release No. 9,972, 2015 WL 6575665, at *19-21 (Oct. 29, 2015).

The Tenth Circuit granted the petition for review and vacated the Commission's decision, holding that SEC ALJs are inferior Officers because they "carry out 'important functions,'" *Bandimere*, 844 F.3d at 1188 (quoting *Freytag*, 501 at 882), and "'exercis[e] significant authority pursuant to the laws of the United States,'" *ibid.* (quoting *Buckley*, 424 U.S. at 126). *Bandimere* recognized that, although this Court "has not stated a specific test for inferior officer status ... 'the term's sweep is unusually broad.'" *Id.* at 1174 (quoting *Free Enter. Fund*, 561 U.S. at 539 (Breyer, J., dissenting)). Drawing from its review of the 150-year history of this Court's cases "contain[ing] examples of inferior officers," the Tenth Circuit concluded that "*Freytag* controls the result." *Id.* at 1173-74. The

court gleaned "three characteristics" of inferior Officers from *Freytag*: (1) their position is "'established by Law'"; (2) their "'duties, salary, and means of appointment ... are specified by statute'"; and (3) they "'exercise significant discretion' in 'carrying out ... important functions.'" *Id.* at 1179 (alterations in original) (quoting *Freytag*, 501 U.S. at 881-82).

As *Bandimere* explained, "[t]hose three characteristics exist" with respect to SEC ALJs. 844 F.3d at 1179. *First*, both the position and the delegated powers of SEC ALJs are established by law. *Ibid.* (citing 5 U.S.C. § 556(b)(3); 17 C.F.R. § 200.14). *Second*, various statutes set forth the duties, salary, and means of appointment of SEC ALJs. *Ibid.* (citing 5 U.S.C. §§ 556-557 (duties); *id.* § 5372(b) (salary); *id.* §§ 1302, 3105 (means of appointment)). *Third*, SEC ALJs "exercise significant discretion in performing 'important functions' commensurate with the STJs' functions described in *Freytag*." *Ibid.* "[B]oth perform similar adjudicative functions," the majority reasoned: "They take testimony, conduct trials, rule on admissibility of evidence, and have the power to enforce compliance with discovery orders." *Id.* at 1181 & n.30 (quoting *Freytag*, 501 U.S. at 881-82).

Bandimere also "spell[ed] out even more of [the] discretionary functions" exercised by SEC ALJs. 844 F.3d at 1181 n.30. For example, SEC ALJs can "shape the administrative record by taking testimony, regulating document production and depositions, ruling on the admissibility of evidence, receiving evidence, ruling on dispositive and procedural motions, issuing subpoenas, and presiding over trial-like hearings." *Id.* at 1179-80 (footnotes omitted). SEC ALJs also "make credibility findings to which the SEC affords 'considerable weight' during agency review,"

"enter default judgments and otherwise steer the outcome of proceedings by holding and requiring attendance at settlement conferences," and "issue initial decisions that declare respondents liable and impose sanctions." *Id.* at 1180-81 (footnotes omitted) (quoting *Bandimere*, 2015 WL 6575665, at *15 n.83). Because SEC ALJs "closely resemble the STJs described in *Freytag*," the Tenth Circuit held that SEC ALJs "are inferior officers who must be appointed as the Constitution commands." *Id.* at 1181.

Judge Briscoe concurred, "fully join[ing]" the majority, and writing separately to explain that an Appointments Clause challenge "requires a position-by-position analysis of the authority Congress by law and a particular executive agency by rule and practice has delegated to its personnel." *Bandimere*, 844 F.3d at 1189 (concurring opinion). "[S]weeping pronouncements" on the constitutional status of other ALJs, Judge Briscoe continued, would be both unnecessary and inappropriate. *Ibid.* This was a pointed response to Judge McKay's dissent, which consisted in large part of such sweeping pronouncements. *See id.* at 1194, 1199-1201 (dissenting opinion).

2. The Tenth Circuit acknowledged that it was "address[ing] the same question," yet reaching the opposite conclusion, as the panel decision in this case. *Bandimere*, 844 F.3d at 1182. The Tenth Circuit expressly rejected both *Landry*'s finality requirement for Officer status *and* the panel's extension of that requirement in this case.

a. Whereas the D.C. Circuit held that under *Landry*, the constitutional analysis "begins, and ends," with whether SEC ALJs "issue final decisions of the Commission," Pet. App. 13a, *Bandimere* expressly rejected the "final authority argument ... that

the D.C. Circuit relied on in *Landry* and *Lucia*." 844 F.3d at 1186; *see also id.* at 1182 ("We disagree ... that final decision-making power is dispositive to the question at hand"). Beginning and ending the Appointments Clause analysis with an official's final decision-making authority, the Tenth Circuit explained, would "ignor[e] the significance of the duties and discretion that [the official] possess[es]," *id.* at 1175 (quoting *Freytag*, 501 U.S. at 881), and "place undue weight" on a factor that, though perhaps "*relevant* in determining whether a public servant exercises significant authority," is not a "*predicate* for inferior officer status," *id.* at 1182-83 (emphases added). The Tenth Circuit thus refused to repeat the D.C. Circuit's mistakes in "mak[ing] final decision-making authority the *sine qua non* of inferior Officer status," and failing to perform a *complete* Appointments Clause analysis. *Id.* at 1189 (Briscoe, J., concurring).

Bandimere squarely rejected, too, the D.C. Circuit's interpretation of *Freytag*'s holding—established in *Landry* and reaffirmed in this case. "[P]roperly read," the Tenth Circuit concluded, "*Freytag* did not place 'exceptional stress' on final decision-making power." 844 F.3d at 1183. Indeed, properly read, *Freytag* said the opposite—that "STJs are inferior officers even though 'the ultimate decisional authority in cases under section 7443A(b)(4) rests with the Tax Court judges.'" *Id.* at 1182 (citation omitted) (discussing 26 U.S.C. § 7443A(b)(4)). *Bandimere* explained that *Freytag*'s discussion of STJs' final decision-making authority in certain cases "did not modify or supplant its holding that STJs were inferior officers based on the 'significance of [their] duties and discretion.'" *Id.* at 1183 (alteration in original) (quoting *Freytag*, 501 U.S. at 881). Rather, that discussion only "reaffirm[ed]" that "the duties of the STJs are sufficiently

significant to make them inferior officers." *Id.* at 1182. Whereas the D.C. Circuit assumed that "*every* inferior officer *must* possess final decision-making power" under *Freytag*, the Tenth Circuit concluded that "*Freytag*'s holding undermines that contention." *Id.* at 1184.

Cementing its disagreement with the decision below, *Bandimere* added that *this* Court has neither "equated significant authority with final decision-making power in *Buckley*, *Freytag*, *Edmond*, or elsewhere," nor "indicated that each of the officers it has deemed inferior possesses that power." 844 F.3d at 1184. In short, the Tenth Circuit resoundingly rejected the D.C. Circuit's exclusive focus on final decision-making authority as having no footing in this Court's teachings.

b. Recognizing that the issue was "not dispositive to [its] holding because it was not dispositive to *Freytag*'s holding," *Bandimere*, 844 F.3d at 1184 n.36, the Tenth Circuit nonetheless concluded that "SEC ALJs exercise significant authority in part because their initial decisions can *and do* become final without plenary agency review," as indeed "90 percent" do, *id.* at 1180 n.25 (emphasis added). The court explained that "the agency has no duty, based on the regulation's plain language, to review an unchallenged initial decision before entering an order stating the decision is final." *Ibid.* (citing 17 C.F.R. § 201.360(d)(2)). In fact, *Bandimere* noted multiple paths for "an initial decision to become final without plenary agency review." *Id.* at 1184 n.36. In the absence of a petition for review, for example, "the agency may simply enter an order stating an initial decision is final *without engaging in any review*." *Ibid.* (emphasis added) (citing 17 C.F.R. § 201.360(d)(2)).

The Tenth Circuit added that, at any rate, under *Edmond* "[t]he SEC's power to review its ALJs does not transform them into lesser functionaries"; "[r]ather, it shows the ALJs are inferior officers subordinate to the SEC commissioners." *Bandimere*, 844 F.3d at 1188 (citing *Edmond*, 520 U.S. at 663). Judge Briscoe thus observed that, even under the D.C. Circuit's "truncated *Freytag* analysis, [*Bandimere*] correctly holds that the SEC's ALJs are inferior Officers." *Id.* at 1194 (concurring opinion).

* * *

As things stand today, SEC ALJs are Officers in the Tenth Circuit but not in the D.C. Circuit. That is an untenable state of affairs given that Congress has authorized review of SEC final decisions *either* in the D.C. Circuit *or* in the regional circuit encompassing the petitioner's residence or principal place of business. 15 U.S.C. § 78y(a)(1). The SEC itself has acknowledged that the situation is unsustainable, staying all administrative proceedings that are appealable to the Tenth Circuit. Order, *In re Pending Administrative Proceedings*, Securities Act Release No. 10,365 (May 22, 2017). The Commission, courts, and parties to SEC proceedings all need to know sooner rather than later whether or not SEC ALJs are Officers who must be appointed pursuant to the Appointments Clause.

III. This Case Is The Ideal Vehicle To Resolve The Question Presented

This case cleanly presents the important and recurring question whether SEC ALJs are Officers of the United States. There are no potential vehicle problems.

The Judiciary has a "strong interest ... in maintaining the constitutional plan of separation of powers." *Freytag*, 501 U.S. at 879 (quoting *Glidden Co.* v. *Zdanok*, 370 U.S. 530, 536 (1962)). That interest is especially strong in the context of the Appointments Clause, which is "among the significant structural safeguards of the constitutional scheme." *Edmond*, 520 U.S. at 659. So important are the "structural" interests implicated by an Appointments Clause challenge that they can "be considered on appeal whether or not they were ruled upon below." *Freytag*, 501 U.S. at 878-79. Because these important structural interests warrant review even where such a challenge has been waived, *see id.* at 879-80, they manifestly warrant review here, where the issue was properly presented in and actually decided by both the agency and the reviewing court.

In part because of the changes wrought by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, the Commission has dramatically increased both the number and proportion of enforcement actions brought in administrative hearings before its ALJs. In 2014, for example, "[t]he SEC brought more than four out of five of its enforcement actions" before its ALJs, "up from less than half of them a decade earlier." Jean Eaglesham, *SEC Wins With In-House Judges*, Wall. St. J. (May 6, 2015). Moreover, the Commission agrees that SEC ALJs' fact-finding and credibility determinations are "a matter of considerable importance" to the Commission's ability to undertake review. Pet. App. 241a. The constitutionality of proceedings before SEC ALJs thus is important to the functioning of the Commission's decision-making apparatus—as well as to the rights of individuals and entities compelled to defend themselves in administrative hearings.

The question presented is also tightly focused. It is undisputed that the five SEC ALJs are not appointed by the President, the head of a department, or a court of law. Pet. App. 87a. It is also undisputed that the only appropriate remedy for an Appointments Clause violation here is vacatur of the challenged orders. *See Freytag*, 501 U.S. at 879; *United States* v. *L.A. Tucker Truck Lines, Inc.*, 344 U.S. 33, 38 (1952) (defect in the appointment of Officer is "an irregularity which would invalidate a resulting order"). The Commission has not argued that the Appointments Clause violation could be excused under a harmless-error, ratification, *de facto* officer, or any other similar doctrine. *See* Pet. App. 9a-10a. And because this case involves a petition for review of agency action, the decision and order under review can be defended only on the grounds articulated by the agency, and the Commission cannot raise any new grounds for the first time in this Court. *See SEC* v. *Chenery Corp.*, 318 U.S. 80, 87 (1943). For example, the constitutionality of ALJ removal procedures and the status of ALJs in other agencies have never been raised by any party in this case (or in *Bandimere*) and thus these are not arguments available to the government here. *But see Bandimere*, 844 F.3d at 1199-1201 (McKay, J., dissenting) (speculating on these issues without benefit of briefing by any party); *see also Bandimere* v. *SEC*, 855 F.3d 1128, 1130-32 (10th Cir. 2017) (Lucero, J., dissenting from denial of rehearing en banc) (similar).

The constitutionality of SEC ALJs has been raised in a number of pending proceedings. Only two of those—this case and *Bandimere*—have reached appellate decisions on the merits of the Appointments Clause question. The same question has also been raised in at least 13 other cases pending in the courts of appeals and 30 proceedings pending before the

Commission. *See* Pet. App. 300a-304a. These figures will only continue to increase until this Court settles the issue. The question presented by this petition—whether SEC ALJs are Officers of the United States—admits of only one answer. This dispute will grow no more ripe, and the issue no better developed, with time. This Court should grant certiorari now, in this case.*

* * *

The SEC's regime of unaccountable adjudicators has left countless casualties on the field—not least Ray Lucia. After an unblemished career spanning forty years, Mr. Lucia has been rendered unemployable in his profession and on the verge of bankruptcy—even though his free presentations, at which no securities were offered or sold and which concededly caused no investor harm, did not remotely amount to intentional fraud. The ALJ who presided over this case imposed on him "'the securities industry equivalent of capital punishment.'" *Saad* v. *SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013) (citation omitted). The Framers designed the Appointments Clause precisely to prevent such abuses of power by unaccountable officials. This Court needs to decide, now, whether SEC ALJs are Officers of the United States.

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*Although the government could petition for a writ of certiorari in *Bandimere*, this case presents a better vehicle for the resolution of the Appointments Clause issue because (unlike *Bandimere*) this case raises no potential recusal issues. The constitutional issue also was more fully briefed in this case: At the en banc stage, petitioners and the government filed replacement briefs devoted solely to the Appointments Clause issue, and six *amicus* briefs were filed supporting petitioners.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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July 21, 2017

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 15-1345 **September Term, 2016**

SEC-3-15006

Filed On: June 26, 2017

Raymond J. Lucia Companies, Inc. and Raymond J. Lucia,

Petitioners

v.

Securities and Exchange Commission,

Respondent

BEFORE: Garland, Chief Judge,* and Henderson, Rogers, Tatel, Brown, Griffith, Kavanaugh, Srinivasan, Millett, Pillard, and Wilkins, Circuit Judges

JUDGMENT

This cause came on to be heard on the petition for review of an order of the Securities & Exchange Commission and was argued by counsel. On consideration thereof, it is

* Chief Judge Garland did not participate in this matter.

ORDERED and **ADJUDGED** that the petition for review is denied by an equally divided court. See D.C. Cir. Rule 35(d).

Per Curiam

FOR THE COURT:
Mark J. Langer, Clerk

BY: /s/

Deputy Clerk

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued May 13, 2016 Decided August 9, 2016

No. 15-1345

RAYMOND J. LUCIA COMPANIES, INC. AND RAYMOND J. LUCIA,
PETITIONERS

V.

SECURITIES AND EXCHANGE COMMISSION,
RESPONDENT

On Petition for Review of an Order of the Securities & Exchange Commission

* * *

Before: ROGERS, PILLARD and WILKINS, *Circuit Judges*.

Opinion for the Court by *Circuit Judge* ROGERS.

ROGERS, *Circuit Judge*: Raymond J. Lucia and Raymond J. Lucia Companies, Inc., petition for review of the decision of the Securities and Exchange Commission imposing sanctions for violations of the Investment Advisers Act of 1940 and the rule against misleading advertising. Upon granting a petition for review of an initial decision by an administrative law judge ("ALJ"), the Commission rejected petitioners'

challenges to the liability and sanctions determinations and petitioners' argument that the administrative hearing was an unconstitutional procedure because the administrative law judge who heard the enforcement action was unconstitutionally appointed. Petitioners now renew these arguments, including that the judge was a constitutional Officer who must be appointed pursuant to the Appointments Clause, U.S. CONST. art. II, § 2, cl. 2. For the following reasons, we deny the petition for review.

I.

In the Securities Exchange Act of 1934, Congress determined that transactions in securities conducted over exchanges and over-the-counter markets were "affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto." 15 U.S.C. § 78b. To carry out the regulation of the securities markets, Congress established the Securities and Exchange Commission, to be composed of five commissioners appointed by the President with the advice and consent of the Senate. *Id.* § 78d(a). Over time Congress expanded the responsibilities of the Commission, and by 1960 it was administering six statutes, *see* 1962 U.S.C.C.A.N. 2150, 2156, including the Investment Advisers Act of 1940, 15 U.S.C. § 80b-21. In 1961, pursuant the Reorganization Act of 1949, Pub. L. No. 81-109, ch. 226, 63 Stat. 203 (now codified as amended at 5 U.S.C. §§ 901–912), the President sent Congress a proposal to allow the Commission to delegate some of its responsibilities to divisions and individuals within the Commission. *See* 1961 U.S.C.C.A.N. 1351, 1351–52. The proposal was designed to provide "for greater flexibility in the han-

dling of the business before the Commission, permitting its disposition at different levels so as better to promote its efficient dispatch." *Id.* at 1351. Further, this ability to delegate tasks would "relieve the Commissioners from the necessity of dealing with many matters of lesser importance and thus conserve their time for the consideration of major matters of policy and planning." *Id.*

In response, Congress enacted "An Act to Authorize the Securities and Exchange Commission to Delegate Certain Functions," Pub L. No. 87-592, 76 Stat. 394, 394–95 (1962). Congress made three main changes to the President's proposal: a single Commissioner's vote was sufficient to require Commission review, the authority to delegate did not extend to the Commission's rulemaking authority, and in certain instances review was mandatory for adversely affected parties in circumstances not at issue here. *Compare* 1961 U.S.C.C.A.N. at 1352, *with* 76 Stat. at 394–95. Except for modification of when Commission review is mandatory, *see* An Act to Amend the Securities and Exchange Act of 1934, Pub. L. No. 94-29, § 25, 89 Stat. 97, 163 (1975), and substitution of "administrative law judge" for "hearing examiner, *see* Pub. L. No. 95-251, § 2(a)(4), 92 Stat. 183, 183 (1978), the current version of the statute, codified at 15 U.S.C. § 78d-1, has not been amended in any material respect since its enactment in 1962, *see* Securities and Exchange Commission Authorization Act of 1987, Pub. L. No. 100-181, § 308, 101 Stat. 1249, 1254–55.

Section 78d-1 has three basic parts. Subsection (a) provides that "the Securities and Exchange Commission shall have the authority to delegate, by published order or rule, any of its functions to a division of the Commission, an individual Commissioner, an

[ALJ], or an employee or employee board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter." 15 U.S.C. § 78d-1(a). Subsection (b) provides that the "Commission shall retain a discretionary right to review the [delegated] action . . . upon its own initiative or upon petition of a party to or intervenor in such action." *Id.* § 78d-1(b). It also lists when Commission review of a petition is mandatory. *Id.* Subsection (c) provides:

> If the [Commission's] right to exercise such review is declined, or if no such review is sought within the time stated in the rules promulgated by the Commission, then the action of any such division of the Commission, individual Commissioner, [ALJ], employee, or employee board, shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission.

Id. § 78d-1(c).

The Commission has authority to pursue alleged violators of the securities laws by filing a civil suit in the federal district court or by instituting a civil administrative action. *See* 15 U.S.C. §§ 78u, 78u-2, 78u-3, 78v; *see also id.* §§ 77h-1, 77t(b), 80b-9. By rule, the Commission has delegated to its ALJs authority to conduct administrative hearings, 17 C.F.R. § 200.30-9, and "[t]o make an initial decision in any proceeding at which the [ALJ] presides in which a hearing is required to be conducted in conformity with the [Administrative Procedure Act ("APA")] (5 U.S.C. 557)," *id.* § 200.30-9(a); *see id.* §§ 200.14, 201.111. The ALJs have authority to, among other things, administer oaths, issue subpoenas, rule on offers of proof, examine witnesses, rule upon motions, *id.* §§ 200.14,

201.111, enter orders of default, *see id.* § 201.155, and punish contemptuous conduct by excluding a contemptuous person from a hearing, *see id.* § 201.180(a); on the other hand, they lack authority to seek court enforcement of subpoenas and have no authority to punish disobedience of discovery orders or other orders with contempt sanctions of fine or imprisonment.

In any event, the Commission retains discretion to review an ALJ's initial decision either on its own initiative or upon a petition for review filed by a party or aggrieved person. 15 U.S.C. § 78d-1(b); *see also* 17 C.F.R. § 201.411(b)–(c). Other than where a petition for review triggers mandatory review, 15 U.S.C. § 78d-1(b); *see also* 17 C.F.R. § 201.411(b)(1), the Commission may deny review, 17 C.F.R. § 201.411(b)(2). By rule, the Commission has established time limits for filing a petition for review, *id.* §§ 201.360(b), 201.410(b), and, when no petition is filed, for ordering review on its own initiative, *id.* § 201.411(c). Further, by rule, the Commission has established a procedure for finalizing its decisions. *Id.* § 201.360(d). If no review of the initial decision is sought or ordered upon the Commission's own initiative, then the Commission will issue an order advising that it has declined review and specifying the "date on which sanctions, if any, take effect"; notice of the order will be published in the Commission's docket and on its website. *Id.* § 201.360(d)(2). Thus, by rule, the initial "decision becomes final upon issuance of the order," *id.*, and then because review has been declined, by statute "the action of" the ALJ, in the initial decision, "shall . . . be deemed the action of the Commission." 15 U.S.C. § 78d-1(c).

Here, the Commission instituted an administrative enforcement action against petitioners for alleged

violations of anti-fraud provisions of the Investment Advisers Act based on how they presented their "Buckets of Money" retirement wealth-management strategy to prospective clients.[1] It ordered an ALJ to conduct a public hearing, *Raymond J. Lucia Cos., Inc.*, Exchange Act Release No. 67781, 2012 WL 3838150 (Sep. 5, 2012), and thereafter an ALJ issued an initial decision finding liability based only on one of the four charged misrepresentations and imposing sanctions, including a lifetime industry bar of Raymond J. Lucia, *Raymond J. Lucia Cos., Inc.*, Initial Decision Release No. 495, 2013 WL 3379719 (July 8, 2013). A month later, the ALJ issued an order on petitioners' motion to correct manifest errors of fact. *Raymond J. Lucia Cos., Inc.*, Administrative Proceedings Rulings Release No. 780 (Aug. 7, 2013). The Commission, *sua sponte*, remanded the case for further findings of fact on the three charges the ALJ had not addressed. The ALJ subsequently issued a revised initial decision. *Raymond J. Lucia Cos., Inc.*, Initial Decision Release No. 540, 2013 WL 6384274 (Dec. 6, 2013) ("initial decision"). Thereafter, the Commission granted petitioners' petition for review and the Enforcement Division's cross-petition for review.

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[1] Sections 206(1), (2), and (4) of the Investment Advisors Act provides that an investment adviser may not (1) "employ any device, scheme, or artifice to defraud any . . . prospective client," (2) "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any . . . prospective client," or (4) "engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." 15 U.S.C. § 80b-6(1), (2), (4). Under Commission Rule 206(4)-1(a)(5) an investment adviser may not "publish, circulate, or distribute any advertisement . . . [w]hich contains any untrue statement of a material fact, or which is otherwise false or misleading." 17 C.F.R. § 275.206(4)-1(a)(5).

"[O]n an independent review of the record," except as to unchallenged factual findings, the Commission found that petitioners committed anti-fraud violations and imposed the same sanctions as the ALJ. *Raymond J. Lucia Cos., Inc.*, Exchange Act Release No. 75837, at 3, 2015 WL 5172953 (Sept. 3, 2015) ("*Decision*"). The Commission also rejected petitioners' argument that the administrative proceeding was unconstitutional because the presiding ALJ was not appointed in accordance with the Appointments Clause under Article II, Section 2, Clause 2 of the Constitution. *Id.* at 28–33. Relying on *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000), the Commission concluded its ALJs are employees, not Officers, and their appointment is not covered by the Clause. *Decision* at 28–33.

II.

Petitioners first contend that the Commission's decision and order under review should be vacated because the ALJ rendering the initial decision was a constitutional Officer who was not appointed pursuant to the Appointments Clause. Because the government does not maintain that the Commission's decision can be upheld if the presiding ALJ was unconstitutionally appointed, we address this issue first because were petitioners to prevail there would be no need to reach their challenges to the liability and sanction determinations. The Commission has acknowledged the ALJ was not appointed as the Clause requires, and the government does not argue harmless error would apply. *See Ryder v. United States*, 515 U.S. 177, 186 (1995). Thus, if the court concludes, upon considering the constitutional issue *de novo*, *see J.J. Cassone Bakery, Inc. v. NLRB*, 554 F.3d 1041, 1044 (D.C. Cir. 2009), that Commission ALJs are Officers within the meaning of

the Appointments Clause, then the ALJ in petitioners' case was unconstitutionally appointed and the court must grant the petition for review.

The Appointments Clause provides that the President:

> shall nominate, and by and with the Advice and Consent of the Senate, shall appoint . . . Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

U.S. CONST. art. II, § 2, cl. 2. Unless provided for elsewhere in the Constitution, "all Officers of the United States are to be appointed in accordance with the Clause." *Buckley v. Valeo*, 424 U.S. 1, 132 (1976). This includes not only executive Officers, but judicial Officers and those of administrative agencies. *See id.* at 132–33. Only those deemed to be employees or other "'lesser functionaries' need not be selected in compliance with the strict requirements of Article II." *Freytag v. Comm'r, Internal Revenue*, 501 U.S. 868, 880 (1991) (quoting *Buckley*, 424 U.S. at 126 n.162). The Clause's limitations are not mere formalities, but have been understood to be "among the significant structural safeguards of the constitutional scheme." *Edmond v. United States*, 520 U.S. 651, 659 (1997). The Clause addresses concerns about diffusion of the appointment power and ensures "that those who wielded it were accountable to political force and the will of the people." *Freytag*, 501 U.S. at 883–84; *see also Ryder*, 515 U.S. at 182.

The Supreme Court has explained that generally an appointee is an Officer, and not an employee who falls beyond the reach of the Clause, if the appointee exercises "significant authority pursuant to the laws of the United States." *Buckley*, 424 U.S. at 126. In that case, the Court held that insofar as the Federal Election Commission ("FEC") had rulemaking authority, primary responsibility for conducting civil litigation, and power to determine eligibility for federal matching funds and federal elective office, only "Officers of the United States" duly appointed in accordance with the Appointments Clause could exercise such powers because each represented "the performance of a significant governmental duty exercised pursuant to a public law"; the commissioners had not been appointed properly and therefore could not. *Buckley*, 424 U.S. at 140–41. So too, in *Freytag*, 501 U.S. 868, where the Court considered the powers and duties of special trial judges, *id.* at 882, who as members of an Article I court could exercise the judicial power of the United States, *id.* at 888–89, to be significant and explained that an appointee is no less an Officer because some of his duties are those of an employee. For that reason, when evaluating whether an appointee is a constitutional Officer, a reviewing court will look not only to the authority exercised in a petitioner's case but to all of that appointee's duties, or at least those called to the court's attention. *See Tucker v. Comm'r, Internal Revenue*, 676 F.3d 1129, 1132 (D.C. Cir. 2012) (citing *Freytag*, 501 U.S. at 882); *Landry*, 204 F.3d at 1131–32.

This court has elaborated on what constitutes an exercise of "significant authority." Once the appointee meets the threshold requirement that the relevant position was "established by Law" and the position's "duties, salary, and means of appointment" are specified

by statute, *Landry*, 204 F.3d at 1133–34 (quoting *Freytag*, 501 U.S. at 881), "the main criteria for drawing the line between inferior Officers and employees not covered by the Clause are (1) the significance of the matters resolved by the officials, (2) the discretion they exercise in reaching their decisions, and (3) the finality of those decisions," *Tucker*, 676 F.3d at 1133; *see Landry*, 204 F.3d at 1133–34. In *Landry*, 204 F.3d at 1134, the court held that the ALJs of the Federal Deposit Insurance Corporation ("FDIC") were not Officers because they did not satisfy the third criterion; unlike the special tax judges in *Freytag*, the FDIC ALJs could not issue final decisions because their authority was limited by FDIC regulations to recommending decisions that the FDIC Board of Directors might issue, *id.* at 1133 (citing 12 C.F.R. § 308.38). This court understood that it "was critical to the Court's decision" in *Freytag* that the special trial judge had authority to issue final decisions in at least some cases, because it would have been "unnecessary" for the Court to consider whether the tax judges had final decision-making power when the judge in Freytag's case exercised no such power. *Id.* (citing *Freytag*, 501 U.S. at 882). Similarly, in *Tucker*, 676 F.3d at 1134, the court held that an employee of the IRS Office of Appeals was not an Officer because regulatory and other constraints — such as detailed guidelines, consultation requirements, and supervision — meant that Appeals employees lacked the discretion required by the second criterion. In both cases, either due to the lack of final decision power or discretion, the appointee could not be said to have been delegated sovereign authority or to have the power to bind third parties, or the government itself, for the public bene-

fit. *See Officers of the United States Within the Meaning of the Appointments Clause*, 31 Op. O.L.C. 73, 87 (2007).

Landry, of course, did not resolve the constitutional status of ALJs for all agencies. *See Landry*, 204 F.3d at 1133–34; *see also Free Enterprise Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 507 n.10 (2010). But to the extent petitioners contend that the approach required by *Landry* is inconsistent with *Freytag* or other Supreme Court precedent, this court has rejected that argument and *Landry* is the law of the circuit, *see LaShawn A. v. Barry*, 87 F.3d 1389, 1395 (D.C. Cir. 1996). For the same reason, the court must reject petitioners' view, relying on *Edmond*, that the ability to "render a final decision on behalf of the United States," while having a bearing on the dividing line between principal and inferior Officers, is irrelevant to the distinction between inferior Officers and employees. Petrs. Br. 25 (quoting *Edmond*, 520 U.S. at 665–66). Moreover, in *Edmond*, 520 U.S. at 656, the Court noted that the government did not dispute that military court appellate judges were Officers and addressed only what type of Officer they were; it had no occasion to address the differences between employees and Officers.

As to the petitioners' contentions about *Landry*'s application to Commission ALJs, the parties principally disagree about whether Commission ALJs issue final decisions of the Commission. Our analysis begins, and ends, there.

Petitioners emphasize the requirement in section 78d-1(c) that the ALJ's "action," when not reviewed by the Commission, "*shall*, for all purposes, including appeal or review thereof, *be deemed* the action of the Commission." (emphasis as added in Petrs. Br. 36).

In their view, the statute contemplates that the ALJ's initial decision becomes final in at least some circumstances when Commission review is declined. "At a minimum," they suggest, "Congress has indisputably *permitted* the [Commission] to treat unappealed ALJ decisions as final." Petrs. Br. 36–37.

The government acknowledges that the statute might have permitted this approach, but emphasizes that subsection (c) of the statute cannot be looked at in isolation because the same statutory provision on which petitioners rely also authorizes the Commission to establish its delegation and review scheme by rule. 15 U.S.C. § 78d-1(a)–(b). There can be no serious question that Section 78d-1(b) reserves to the Commission "a discretionary right to review the action of any" ALJ as it sees fit. And the Commission promulgated rules to govern that review pursuant to its general rulemaking authority under the security laws. *See Decision* at 31 n.109 (citing 17 C.F.R. § 201.360(d)(2)); *see also* 15 U.S.C. § 78w(a)(1). For the purposes of the Appointments Clause, the Commission's regulations on the scope of its ALJ's authority are no less controlling than the FDIC regulations to which this court looked in *Landry*, 204 F.3d at 1133 (citing 12 C.F.R. §§ 308.38, 308.40(a), (c)).

So understood, the Commission *could* have chosen to adopt regulations whereby an ALJ's initial decision would be deemed a final decision of the Commission upon the expiration of a review period, without any additional Commission action. But that is not what the Commission has done. Instead, by rule the Commission, as relevant, has defined when its "right to exercise [Section 78d-1(b)] review is declined" and has established the process by which an initial decision can become final and thereby "be deemed the action of

the Commission," 15 U.S.C. § 78d-1(c). First, it has afforded itself additional time to determine whether it wishes to order review even when no petition for review is filed. 17 C.F.R. § 201.411(c). Second, upon deciding not to order review, the Commission issues an order stating that it has decided not to review the initial decision and setting the date when the sanctions, if any, take effect. *Id.* § 201.360(d)(2).

Although petitioners maintain that the finality order cannot transform the ALJ's initial decision into a mere recommendation because the "confirmatory order is a ministerial formality, akin to a court clerk's automatic issuance of the mandate after the time for seeking appellate review has expired," Petrs. Br. 36, the Commission has explained that the order plays a more critical role. Until the Commission determines not to order review, within the time allowed by its rules, *see e.g.*, 17 C.F.R. §§ 201.360(d)(2), 201.411(c), there is no final decision that can "be deemed the action of the Commission," 15 U.S.C. § 78d-1(c). As the Commission has emphasized, the initial decision becomes final when, and only when, the Commission issues the finality order, and not before then. *See Decision* at 31. Thus, the Commission must affirmatively act — by issuing the order — in every case. The Commission's final action is either in the form of a new decision after *de novo* review or, by declining to grant or order review, its embrace of the ALJ's initial decision as its own. In either event, the Commission has retained full decision-making powers, and the mere passage of time is not enough to establish finality. And even when there is not full review by the Commission, it is the act of issuing the finality order that makes the initial decision the action of the Commission within the meaning of the delegation statute. Indeed, as this court observed in *Jarkesy v. SEC*, 803 F.3d 9,

12–13 (D.C. Cir. 2015) (citing 17 C.F.R. §§ 201.360(d)(2), 201.411(a)), in holding that exhaustion of constitutional issues was required, the Commission alone issues final orders.

Put otherwise, the Commission's ALJs neither have been delegated sovereign authority to act independently of the Commission nor, by other means established by Congress, do they have the power to bind third parties, or the government itself, for the public benefit. *See* 31 Op. OLC at 87. The Commission's right of discretionary review under Section 78d-1(b) and adoption of its regulatory scheme for delegation pursuant to Section 78d-1(c) ensure that the politically accountable Commissioners have determined that an ALJ's initial decision is to be the final action of the Commission.

Petitioners object generally to this understanding of the Commission's delegation scheme, but it cannot seriously be argued that the Commission's regulatory scheme is not a reasonable interpretation of the statute, specifically defining the circumstances under which its "right to exercise . . . review is declined," 15 U.S.C. § 78d-1(c), and that the Commission's interpretation of the finality order is a reasonable interpretation of its regulations. *See Christopher SmithKline Beecham Corp.*, 132 S. Ct. 156, 2165–66 (2012). Further, nothing in the legislative history of Section 78d-1, the regulatory history of 17 C.F.R. § 201.360(d), or Commission precedent indicates Congress or the Commission intended that the ALJ who presides at an enforcement proceedings be delegated the sovereign power of the Commission to make the final decision. This is consistent with Congress's adoption of the President's reorganization proposal to provide "for

greater flexibility in the handling of the business before the Commission," and "relieve the Commissioners from the necessity of dealing with many matters of lesser importance and thus conserve their time for the consideration of major matters of policy and planning." 1961 U.S.C.C.A.N. at 1351. The history of the Commission's finality regulation, 17 C.F.R. § 201.360(d)(2), demonstrates that the finality order was and remains an after-the-fact statement to the parties that the Commission has declined to order review. *See* 17 C.F.R. § 201.360(d)(1) (1995); Proposed Amendments to the Rules of Practice and Related Provisions, Exchange Act Release No. 34-48832, 2003 WL 22827684, at *12 (Nov. 23, 2003). And the Commission's precedent in *Alchemy Ventures, Inc.*, Release No. 70708, 2013 WL 6173809 (Oct. 17, 2013); *see* Petrs. Br. 32 n.5, resolved an ambiguity, ruling that even in cases of defaults ALJs must issue initial decisions as required by Commission rules; it left enforceable outstanding default orders but made clear that ALJs do not have authority to proceed without issuing initial decisions. *Id.* at *2–4 (citing 17 C.F.R. § 201.360(d)).

Because the Commission has reasonably interpreted its regulatory regime to mean that no initial decision of its ALJs is independently final, such initial decisions are no more final than the recommended decisions issued by FDIC ALJs. This is so even though the FDIC's regulations limit its ALJs to issuing "recommended decisions" and require the FDIC to consider and decide every case, whereas the Commission can choose not to order or grant full review of a case. Based on the Commission's interpretation of its delegation scheme, the difference between the FDIC's recommended decisions and the Commission's initial decisions is "illusory." Resp't. Br. 28. As discussed, the

Commission can always grant review on its own initiative, and so it must consider every initial decision, including those in which it does not order review. 15 U.S.C. § 78d-1(b); 17 C.F.R. §§ 201.360(d)(2), 201.411(c). It gives itself time to decide whether to order review and must always issue a finality order to indicate whether it has declined review. 17 C.F.R. §§ 201.360(d)(2), 201.411(c). Petitioners offer neither reason to understand the finality order to be merely a rubber stamp, nor evidence that initial decisions of which the Commission does not order full review receive no substantive consideration as part of this process. That is, petitioners have not substantiated that a finality order is just like a clerk automatically issuing a mandate, Petrs. Br. 36, and, in so asserting, have ignored that clerks have no authority to review orders or decline to issue mandates. It is also worth noting that the differences between the two regimes are not as stark as petitioners suggest. In either the FDIC or Commission system, issues of law and fact can go unreviewed; the FDIC's regulations do not require the Board to consider issues of fact and law unless a party raises the issue before the Board (after having raised it before an ALJ), *see* 12 C.F.R. § 308.40(c)(1); *see also id.* § 308.39(b)(2).

In a further attempt to distinguish the FDIC regime considered in *Landry*, petitioners contend that even if Commission ALJs do not issue final decisions, they still exercise greater authority than FDIC ALJs in view of differences in the scope of review of the ALJ's decisions. But the Commission's scope of review is no more deferential than that of the FDIC Board. It reviews an ALJ's decision *de novo* and "may affirm, reverse, modify, [or] set aside" the initial decision, "in whole or in part," and it "may make any findings or conclusions that in its judgment are proper and on the

basis of the record." 17 C.F.R. § 201.411(a). It "ultimately controls the record for review and decides what is in the record." *Decision* at 31. It may "remand for further proceedings," 17 C.F.R. § 201.411(a), as it did in petitioners' case, "remand . . . for the taking of additional evidence," or "hear additional evidence" itself. *Id.* § 201.452. Furthermore, if "a majority of participating Commissioners do not agree to a disposition on the merits, the initial decision shall be of no effect." *Id.* § 201.411(f). To the same extent the Commission may sometimes defer to the credibility determinations of its ALJs, *see, e.g.*, *Clawson*, Exchange Act Release No. 48143, 2003 WL 21539920, at *2 (July 9, 2003), so too may the FDIC, *see Landry*, 1999 WL 440608, at *23 (May 25, 1999). The FDIC and the Commission may defer to credibility determinations where the record provides no basis for disturbing the finding, but an agency is not required to adopt the credibility determinations of an ALJ, *see Kay v. FCC*, 396 F.3d 1184, 1189 (D.C. Cir. 2005) (citing 5 U.S.C. § 557(b)). By contrast, the Tax Court in *Freytag* was "required to defer" to the special trial judge's "factual and credibility findings unless they were clearly erroneous," *Landry*, 204 F.3d at 1133. Petitioners' reliance on 17 C.F.R. § 201.411(b)(2)(ii)(A) is misplaced; that rule refers to the criteria the Commission considers in deciding whether to grant a petition for review, not the subsequent proceedings, *see* 17 C.F.R. § 201.411(a), and not the Commission's determination of whether to order *sua sponte* review, *see id.* § 201.411(c).

Contrary to petitioners' suggestion, the Commission's treatment of a Commission ALJ's initial decision is not inconsistent with the treatment given to initial decisions in the APA, which provides where an agency does not exercise its authority of review, the ALJ's initial decision "becomes the decision of the

agency without further proceedings." 5 U.S.C. § 557(b); *see also* U.S. Dep't of Justice, *Attorney General's Manual on the Administrative Procedure Act* 82–83 (1947). As discussed, an initial decision is "deemed to be the decision of the Commission" but only after that decision has been embraced by the Commissioners as their own. Even though the APA may permit agencies to establish different processes, whereby an ALJ's initial decision can become final and binding on third parties, the Commission was not required to do so. Congress considered and rejected proposals to transfer final decision-making authority from agency officials to presidentially appointed judges in a separate administrative court with powers similar to those generally vested in Article I courts. *See* H.R. Rep. No. 79-1980, at 8 (1946), *reprinted in Legislative History of Administrative Procedure Act*, at 242 (1946). It determined hearing examiners (now ALJs) should continue to be located within each agency and should have independence within the Civil Service System with regard to tenure and compensation. *See Ramspeck v. Federal Trial Exam'rs Conference*, 345 U.S. 128, 132 & n.2 (1953). But that independence did not mean they were unaccountable to the agency for which they are working. The *Attorney General's Manual on the Administrative Procedure Act* 83, explained Congress envisioned that notwithstanding an ALJ's initial decision, the agency could retain "complete freedom of decision." As a contemporaneous interpretation, the Manual is given "considerable weight." *Brock v. Cathedral Bluffs Shale Oil Co.*, 796 F.2d 533, 537 (D.C. Cir. 1986) (quoting *Pacific Gas & Elec. Co. v. FPC*, 506 F.2d 33, 38 n.17 (D.C. Cir. 1974) (noting active role played by the Attorney General in the formation and implementation of the APA)). The APA provides, thus, that on appeal from

or review of the initial decision, the agency "has all the powers which it would have in making the initial decision," and even on questions of fact, *Kay*, 396 F.3d at 1189 (quoting 5 U.S.C. § 557). "an agency reviewing an ALJ decision is not in a position analogous to a court of appeals reviewing a case tried to a district court," *id.* In this way, Congress left to the agency the flexibility to have final authority in agency proceedings while providing Civil Service protections to ALJs in response to concerns their actions were influenced by a desire to curry favor with agency heads. *See Ramspeck*, 345 U.S. at 132 & n.3, 142.

Finally, petitioners point to nothing in the securities laws that suggests Congress intended that Commission ALJs be appointed as if Officers. They do point to the reference to "officers of the Commission" in 15 U.S.C. § 77u, but there is no indication Congress intended these officers to be synonymous with "Officers of the United States" under the Appointments Clause. Of course, petitioners contend that Congress was constitutionally required to make the Commission ALJs inferior Officers based on the duties they perform. But having failed to demonstrate that Commission ALJs perform such duties as would invoke that requirement, this court could not cast aside a carefully devised scheme established after years of legislative consideration and agency implementation. *See* 5 U.S.C. §§ 3105, 3313; *see also* Civil Service Reform Act of 1978, Pub. L. 95-454, 92 Stat. 1111.

III.

We turn, then, to petitioners' challenges to the Commission's liability findings and its choice of sanction, principally on the ground that punishment is being imposed for conduct that was not unlawful at the

time it occurred. They view the Enforcement Division's "entire case" to have been that petitioners misled investors by describing their presentation of how their "Buckets-of-Money" strategy would have performed historically as a "backtest" even though it was not based only on historical data and instead utilized a mix of historical data and assumptions. Petrs. Br. 45. In their view, the presentation set forth all of the assumptions that went into their backtests and so could not have been understood to have relied only on historical data.

A.

The question for the court is whether there was substantial evidence to support the Commission's determination that, by touting their investment strategy through the false promise of "backtested" historical success, petitioners violated the antifraud provisions of the Investment Advisers Act. *See Koch v. SEC*, 793 F.3d 147, 151–52 (D.C. Cir. 2015) (quoting 15 U.S.C. §§ 78y(a)(4), 80b-13(a)); *Kornman v. SEC*, 592 F.3d 173, 184 (D.C. Cir. 2010). Our review is deferential. Substantial evidence means only "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." *Koch*, 793 F.3d at 151–52 (quoting *Pierce v. Underwood*, 487 U.S. 552, 565 (1988)). The Commission's "conclusions may be set aside only if arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." *Id.* at 152 (quoting *Graham v. SEC*, 222 F.3d 994, 999–1000 (D.C. Cir. 2000)); *see also Rapoport v. SEC*, 682 F.3d 98, 103 (D.C. Cir. 2012).

The Commission found that petitioners had violated the Investment Advisers Act, *see supra* note 1, as a result of factual misrepresentations they made in

their presentations at free retirement-planning seminars. During these presentations, petitioners advocated a "Buckets-of-Money" investment strategy, which called for spreading investments among several types of assets that vary in degrees of risk and liquidity. The core benefit of the strategy, petitioners claimed, was that prospective clients could live comfortably off of their investment income while also leaving a large inheritance. During nearly forty seminars, petitioners used a slideshow to illustrate how this strategy would have performed relative to other common investment strategies. Rather than present a purely hypothetical example about how the strategy might perform, petitioners illustrated how the investment strategy would have performed for a fictional couple retiring during the historic economic downturns in the "1973/74 Grizzly Bear" market and in 1966. Each example showed that a couple using the "Buckets-of-Money" strategy would have increased the value of their investments despite the market downturns and would have done much better than those utilizing other investment strategies.

To find violations of Sections 206(1), (2), and (4) of the Investment Advisers Act, the Commission required evidence from which it could find that petitioners made statements that were misleading either because they misstated a fact or omitted a fact necessary to clarify the statement, and that those misstatements or omissions were material. *Decision* at 17; 15 U.S.C. § 80b-6(1), (2), (4). In addition, for a violation of Section 206(1), the Commission needed evidence that those statements were made with scienter. *Decision* at 17.

The Commission found that petitioners' "Buckets-of- Money" presentation was misleading for three reasons:

1. Petitioners misled prospective investors by stating that they were backtesting the "Buckets-of-Money" investment strategy. *Decision* at 17–18. The actual testing had not used only historical data and instead relied on a mix of historical data and assumptions about the inflation rate and the rate of return on one type of asset on which the strategy relied, Real Estate Investment Trusts ("REITs"). *Id.* at 17–18, 23–26. Petitioners presented their investment strategy as so effective that it would have weathered historical periods of market volatility, and nowhere suggested that they were presenting mere abstract hypotheticals. In that context, stating as "backtest" results figures that did not rely exclusively on historical data was misleading. *Id.* In addition, petitioners should not have been able to say that they backtested the "Buckets-of-Money" investment strategy when they had failed to implement what petitioners had described as a key part of the strategy: shifting (or "rebucketizing") assets from the riskiest buckets of assets to safer buckets of assets once assets in the safest buckets were spent. *Id.* at 18–19, 25. This "rebucketizing" ensured that prospective investors would never have all of their assets in the riskiest bucket.

2. Petitioners misled prospective investors by presenting the *results* that they featured in their presentations. *Id.* at 18. Petitioners represented that individuals using their "Buckets-of-Money" investment strategy starting in 1966 or 1973 would have seen the value of their investments increase. This result was based on flawed assumptions because petitioners underestimated the effect of inflation and

overestimated the expected REIT returns, thereby dramatically departing from historical reality. *See id.* Further, the failure to "rebucketize" meant that the presented result was based on an artificially high percentage of assets in stocks during the time the stock market happened to be performing well. *Id.* at 18–19. Had petitioners utilized more realistic estimates and "rebucketized," as they insisted their strategy required, they would have had to show that the "Buckets-of-Money" investment strategy had run out of assets rather than grown as advertised. *Id.* at 18.

3. Petitioners' stated result of the 1973 backtest was misleading because, even using their assumptions, the result could not be replicated and because petitioners failed to provide any documentary support for the result they presented to prospective clients. *Id.* at 17, 19. Thus, petitioners "either fabricated the 1973 backtest result or presented it to seminar attendees without ensuring its accuracy." *Id.* at 19.

The Commission also found that these misrepresentations were material because they would have been significant to a reasonable investor in determining whether to adopt the "Buckets-of-Money" investment strategy. *Id.* at 19 & n.63 (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988)). In support, the Commission referenced testimony from potential investors who were present during some of the presentations. Further, because petitioners designed the slides and would have been aware of the risk of misleading prospective clients as a result of their misrepresentations, the Commission found that petitioners acted with scienter because they had been at least reckless in presenting the backtest slides. *Id.* at 19–20.

Petitioners challenge all three bases for the Commission's determination that the slides were misleading as well as the materiality of the misstatement of the 1973 results and the finding of scienter. When viewed in the context of the presentation, as a whole, petitioners maintain that there was not substantial evidence to support the Commission's finding that they misled prospective clients by stating that they had backtested the "Buckets-of-Money" investment strategy. Rather, they claim, the absence of any settled meaning of the term "backtest" meant that their use of the term, standing alone, did not necessarily imply that the "backtest" analysis would use only historical data. Such an implication was all the more remarkable, in petitioners' view, given the disclaimers on their slides stating that this particular backtest would utilize some hypothetical assumptions. Further, in their view, it was not misleading to state they had backtested the "Buckets-of-Money" investment strategy even if they had not "rebucketized" the assets in the way initially described in the strategy. Although petitioners acknowledge that they referenced "rebucketizing" in the slides, their view is that there was no evidence that "rebucketizing" was a necessary — as opposed to an optional and more advanced — component of the "Buckets-of-Money" investment strategy.

There is substantial evidence to support the Commission's finding that petitioners' "Buckets-of-Money" presentation promised to provide an historical-data-only backtest where the analysis would account for "rebucketizing." As the Commission found, experts for petitioners and the government agreed that the term backtest typically referred to the use of historical, not assumed, data. *Id.* at 17. The Commission emphasized that petitioners "introduced no expert

testimony to establish industry practice, and their own inflation and REIT experts agreed that backtests use historical rates." *Id.* at 26. The Commission accorded little weight to a single mutual fund promotional brochure emphasized by petitioners because, although the brochure used the term backtest in connection with an assumed inflation rate, two other brochures used historical rates in connection with their backtests. *Id.*

Furthermore, the Commission did not rest its analysis exclusively on petitioners' use of the word "backtest" or the Commission's understanding that the term meant an historical-data-only analysis. In response to petitioners' argument that it would be unfair for the Commission to apply a newly established definition to find petitioners conduct unlawful, the Commission explained that it was not attempting to define "backtest" for all purposes. *Id.* at 25. Rather, what was misleading was the statement to seminar attendees that petitioners had analyzed how the "Buckets-of-Money" investment strategy would have performed in the past. *Id.* That is, not only had petitioners used the word "backtest" in their presentations, they had also introduced both historical illustrations (1973 and 1966) by asking what would have happened had a couple used the "Buckets-of-Money" investment strategy at these times. To answer accurately how the strategy would have performed historically would require the use of historical data. Thus, it was misleading for petitioners not to inform seminar attendees that petitioners' backtest could not accurately answer that question. *Id.* And for that reason, even though the presentation contained disclaimers that some assumptions would be used in the historical backtests, the Commission concluded that petitioners had not altered "the overall impression that

[they] had performed backtests showing how the ["Buckets-of-Money" investment] strategy would have performed during the two historical periods." *Id.* at 23.

Petitioners likewise fail to undermine the Commission's finding that a slide purporting to backtest the "Buckets-of-Money" investment strategy would be understood by a reasonable investor to include "rebucketizing" of assets. *Id.* at 25. Contrary to the government's suggestion, petitioners did argue to the Commission that "rebucketizing" was not an essential part of the "Buckets-of-Money" investment strategy, *see* Petrs. Br. to Comm'n 14–15 (2014). The Commission rejected that argument and substantial evidence supports its finding that "rebucketizing" was an essential part of the "Buckets-of-Money" investment strategy so that any purported backtest of that strategy would imply that "rebucketizing" was taking place. Raymond J. Lucia acknowledged that an investor should never have one-hundred percent of his assets in stocks, and made related statements that an investor should not draw income directly from his stock portfolio, both of which would have been necessary over the period of the backtests absent "rebucketizing." *Decision* at 14. Further, when petitioners first introduced the "Buckets-of-Money" investment strategy in their presentation, a slide stated that "rebucketizing" would take place after the non-stock income buckets were exhausted as funds were used for living expenses. Because petitioners never made clear in their presentations that the historical analyses did not include "rebucketizing," and there is no evidence that the backtest must have been understood not to include "rebucketizing," the Commission's finding that "rebucketizing" was essential is supported by substantial evidence in the record.

Petitioners also fail to show that the Commission erred in finding that it was misleading for them to present results that overstated how the "Buckets-of-Money" investment strategy would have performed historically. *Id.* at 18. As the Commission found, petitioners' assumed inflation and REIT rates were [flawed] and had the effect of dramatically overstating the results of the historical analysis. *Id.* at 18–19. For example, the use of a flat 3% inflation rate understated the effect of inflation when the actual inflation rate reached double digits in the late 1970s and early 1980s. *Id.* at 18. Also, the failure to "rebucketize" had the effect of overstating gains. *Id.* at 18–19. Petitioners attempt to justify the use of assumptions generally, referencing the disclaimers in the slides, but nowhere maintain that the assumptions they chose could be expected to produce results that approximated historic performance. *Id.*

Petitioners take another tack in challenging the Commission's finding that using petitioners' flawed assumptions would not produce the 1973 backtest result represented in the slides. Here, they principally maintain that the Commission never charged the error in the 1973 backtest result and that they therefore had no notice that the erroneous result was under scrutiny. In fact, the charging document provided adequate notice. Incorporating the facts underlying the alleged violations, the charging document alleged that petitioners "failed to keep adequate records" and that the spreadsheet records they maintained failed to "duplicate the advertised investment strategy." *Raymond J. Lucia Cos., Inc.*, Exchange Act Release No. 67781, at 9. The Commission's finding that the 1973 backtest result was either "fabricated" or inaccurate was an outgrowth of this charge as it became clear there was no documentary proof of the presented 1973

backtest result. *Decision* at 8, 19. Petitioners admitted during the hearing that the spreadsheets they produced to substantiate the result were not actually used and included different assumptions than were relied upon in the 1973 backtest shown to potential investors. *Id.* They also admitted that the assumptions presented in the slides could not be used to generate documentary proof of the 1973 result because they had used a different set of assumptions. *Id.* Further, petitioners' expert repeated the analysis with this different set of assumptions and still was unable to replicate the 1973 result. *Id.* The Commission's finding that it was misleading for petitioners to present a result for which they had no support, particularly when the result overstated the success of the "Buckets-of-Money" investment strategy, is supported by substantial evidence.

Petitioners' challenge to the Commission's finding that the misstatement about the 1973 backtest result was material is no more persuasive. A statement is "material" so long as there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.* 426 U.S. 438, 449 (1976)). Petitioners suggest that the misrepresentation could not have been material because the 1973 result presented in the slide understated the success of using the "Buckets-of-Money" investment strategy. But this suggestion rests solely on the 1973 backtest result spreadsheet, which petitioners admitted did not serve as the basis for the 1973 backtest analysis shown in the presentation. Further, petitioners' experts provided substantial evidence to

support the Commission's finding that the slides overstated the 1973 backtest result. *Id.* at 19. The Commission had ample grounds to conclude that the reasonable investor would want to know that petitioners lacked documentary support for the number presented.

Finally, petitioners challenge the Commission's scienter finding. Under section 206(1), which prohibits an investment adviser from employing "any device, scheme, or artifice to defraud any client or prospective client," 15 U.S.C. § 80b-6(1), the Commission must find that petitioners acted with an "intent to deceive, manipulate, or defraud." *SEC v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976)). "[E]xtreme recklessness may also satisfy this intent requirement." *Id.* This is "not merely a heightened form of ordinary negligence" but "an 'extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.'" *Id.* at 641–42 (quoting *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)).

To the extent petitioners maintain the Commission could not have found that they acted with scienter by misleadingly using the term "backtest" because the term did not have a settled meaning at the time, they misunderstand the basis of the Commission's scienter determination. The finding of recklessness did not focus only on petitioners' use of the term, but also focused on petitioners' presentation of slides that promised an historically accurate view of how the "Buckets-of-Money" investment strategy would have

performed during periods of historic economic downturns. Petitioners' effort to read ambiguity into the term "backtest" misses the key point: Whether they referred to their examples as "historical views," "retrospective applications," or "backtests," the misleading impression is the same. For that reason, the Commission found that petitioners either "knew or must have known of the risk of misleading prospective clients to believe that [petitioners] had performed actual backtests." *Decision* at 20. Because they knew historical inflation rates were higher than their assumed rate, that a key asset (REITs) did not perform as assumed, and that not "rebucketizing" would lead to higher returns, petitioners faced an obvious risk of presenting misleading results. *See id.*

There is no record support for petitioners' objection that the Commission could not have found scienter because they sought advance approval of their slides by the Commission as well as by two FINRA-registered broker-dealers. They offer no record basis to undermine the Commission's finding that there was no evidence petitioners had flagged the backtest slides for review or had provided the materials necessary to engage in meaningful review. *See id.* at 27–28. Petitioners ignore the Commission's reliance on a December 12, 2003, letter from Commission staff stating that petitioners "should not assume that [the] activities not discussed in this letter are in full compliance with the federal securities law." *Id.* at 28. The record thus does not show that petitioners took good-faith steps to seek advance approval of the statements that the Commission found they must have known to be misleading.

B.

The court's review of petitioners' challenge to the Commission's choice of sanctions is especially deferential. Because Congress has entrusted to the Commissioners' expertise the responsibility to select the means of achieving the statutory policy in relation to the appropriate remedy, their judgment regarding sanctions is "entitled to the greatest weight." *Kornman*, 592 F.3d at 186 (quoting *Am. Power & Light v. SEC*, 329 U.S. 90, 112 (1946)). The Commission must explain its reasons for selecting a particular sanction but it is not required to follow "any mechanistic formula." *See id.* (citing *PAZ Sec., Inc. v. SEC*, 566 F.3d 1172, 1175 (D.C. Cir. 2009)). The court will intervene "only if the remedy chosen is unwarranted in law or is without justification in fact." *Id.* (quoting *Am. Power & Light*, 329 U.S. at 112–13).

The only sanction petitioners challenge is the imposition of the lifetime industry bar on Raymond J. Lucia, and that challenge is unpersuasive. The Commission adequately explained the reasons for concluding that it was in the public interest to bar him from associating with an investment advisor, broker, or dealer under the Investment Advisers Act, *see* 15 U.S.C. § 80b-3(f). Upon applying the factors set forth in *Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), the Commission concluded that a bar was necessary to "protect[] the trading public from further harm," having found that his misconduct was egregious and recurrent, *Decision* at 34–35 (citation omitted). He violated a fiduciary duty he owed to his prospective clients and did so repeatedly over the course of dozens of seminars. *Id.* at 35. He acted with a "high degree of scienter because he knowingly or recklessly

misled prospective clients for the purpose of increasing [the corporation's] client base and fees generated therefrom." *Id.* Further, such behavior could be expected in the future because he had violated his fiduciary duties and failed to recognize the wrongful nature of his conduct. *Id.* In the Commission's view, the steps he had taken — such as selling his assets in the corporation and withdrawing its investment advisor registration — were insufficient to show that he would not engage in similar misconduct in the future. *Id.* at 35–36. He was still seeking to serve as an on-demand public speaker, consultant, and media personality on retirement planning and other topics. *See id.* at 35–36 & n.132. Although acknowledging that he had stopped presenting the fraudulent backtest slides once the Commission informed him in 2010 of problems with the presentation and that he did not presently threaten to associate with an investment adviser, the Commission considered that these factors were outweighed by his recurrent and intentional misconduct and the "reasonable likelihood that, without a bar, [he] will again threaten the public interest by reassociating with an investment advisor, broker, or dealer." *Id.* at 35–36.

The Commission was unpersuaded that the evidence offered in mitigation lessened the gravity of his conduct or made it less likely that he would engage in such conduct in the future. *Id.* at 36–38. In its view, neither the possible financial losses he would suffer as a result of the permanent industry bar nor the absence of prior misconduct during forty years of working in the industry made his misconduct any less grave. "Here," the Commission concluded, "even without investor injury as an aggravating factor, [his] misconduct was egregious and a bar is in the public interest" inasmuch as its "public interest analysis focuses

on the welfare of investors generally and the threat one poses to investors and the markets in the future." *Id.* at 37 (internal citation and alteration omitted). With respect to the request for an alternative sanction of censure and monitoring, the Commission noted that it had no obligation to impose sanctions similar to those imposed in settled proceedings, where "the avoidance of time-and-manpower-consuming adversary proceedings[] justif[ied] accepting lesser remedies in settlement," *id.* at 38, and emphasized that the appropriate remedy "depends on the facts and circumstances presented" in each case, *see id.*

The record is thus contrary to petitioners' position that the Commission abused its discretion by failing to offer a sufficient justification for imposing the lifetime industry bar. *See Kornman*, 592 F.3d at 188; *see also Seghers v. SEC*, 548 F.3d 129, 135–36 (D.C. Cir. 2008). Undoubtedly the lifetime bar is a most serious sanction, *see Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013), and, in petitioners' view, more serious than the sanctions imposed for similar conduct in settled cases, *see* Petrs. Br. 61. The court, however, will not intervene simply because the Commission exercised its "discretion to impose a lesser sanction" in other cases, *see Kornman*, 592 F.3d at 186–88, for the "'Commission is not obligated to make its sanctions uniform,' and the court 'will not compare this sanction to those imposed in previous cases,'" *id.* at 188 (quoting *Geiger v. SEC*, 363 F.3d 481, 488 (D.C. Cir. 2004)); *see also Seghers*, 548 F.3d at 135. Indeed, the court has stated more broadly, that the Commission need not choose "the least onerous of the sanctions." *PAZ Sec.*, 566 F.3d at 1176. Here, the Commission considered the proposed alternative sanctions and determined, in its judgment, that they would not have been sufficient to protect investors. *Decision* at 37–38. In view of the

Commission's findings that he repeatedly and recklessly engaged in egregious conduct without regard to his fiduciary duty to his clients, petitioners fail to show that the Commission's sanction was unwarranted as a matter of policy or without justification in fact, or that it failed to consider adequately his evidence of mitigation.

Accordingly, we deny the petition for review.

APPENDIX C

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 75837 / September 3, 2015

INVESTMENT ADVISERS ACT OF 1940
Release No. 4190 / September 3, 2015

INVESTMENT COMPANY ACT OF 1940
Release No. 31806 / September 3, 2015

Admin. Proc. File No. 3-15006

In the Matter of
RAYMOND J. LUCIA COMPANIES, INC.
and
RAYMOND J. LUCIA, SR.

OPINION OF THE COMMISSION

CEASE-AND-DESIST PROCEEDING

INVESTMENT ADVISER PROCEEDING

INVESTMENT COMPANY PROCEEDING

Grounds for Remedial Action

Antifraud Violations

Former registered investment adviser and its owner committed securities fraud by making material misrepresentations to prospective clients about their retirement wealth management strategy. *Held*, it is in the public interest to bar the owner from associating with an investment adviser, broker, or dealer; revoke respondents' investment adviser registrations;

order respondents to cease and desist from further violations of the provisions violated; and order civil penalties of $250,000 against the investment adviser and $50,000 against the owner.

* * *

Appeal filed: December 27, 2013
Last brief received: July 13, 2015
Oral Argument: July 31, 2015

I. Introduction

Respondents have appealed, and the Division of Enforcement has cross-appealed, an initial decision finding that Raymond J. Lucia Companies, Inc. ("RJLC"), violated Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 by misleading prospective clients about its Buckets of Money ("BOM") retirement wealth management strategy, and that Raymond J. Lucia, Sr. ("Lucia" and, with RJLC, "Respondents"), aided and abetted and caused RJLC's violations.[1] In particular, the Administrative Law Judge ("ALJ") found that, at seminars Respondents conducted to pitch their BOM strategy to prospective clients, Respondents misrepresented that they had performed two backtests (one from 1966 to 2003 and another from 1973 to 1994) proving that a model portfolio following the BOM strategy during difficult historical market periods would substantially increase in value while also providing annual retirement income. Respondents' statements about the

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[1] *Raymond J. Lucia Cos., Inc.*, Initial Decision Release No. 540, 2013 WL 6384274 (Dec. 6, 2013). Lucia owned RJLC, which was registered with the Commission as an investment adviser from September 2002 through December 2011. Lucia, who was also a registered investment adviser, sold RJLC's assets in 2010 to his son, Raymond J. Lucia, Jr. RJLC is now defunct.

backtests were misleading, the ALJ found, because Respondents did not inform prospective clients that the backtests (i) used assumed inflation and Real Estate Investment Trust ("REIT") rates that did not reflect historical rates, (ii) did not deduct advisory fees, and (iii) did not actually follow the BOM strategy by "rebucketizing" (*i.e.*, reallocating assets between "buckets" of portfolio assets). The ALJ found that Respondents did not inform prospective clients that actual backtests would have shown their model portfolio exhausting its assets before the end of the backtest periods rather than substantially increasing in value.

For these violations, the ALJ barred Lucia from associating with an investment adviser, broker, or dealer; revoked RJLC's and Lucia's investment adviser registrations; ordered RJLC and Lucia to cease and desist from further violations of the Advisers Act; and imposed civil penalties of $250,000 on RJLC and $50,000 on Lucia.

The ALJ also found that RJLC did not violate, and Lucia did not aid and abet and cause a violation of, Advisers Act Rule 206(4)-1(a)(5) concerning fraudulent advertisements by investment advisers because he found that Respondents' live slideshow presentation did not qualify as an "advertisement" under that rule. The ALJ further found that RJLC did not violate Advisers Act Section 204 concerning the maintenance of records by investment advisers.[2] The Division cross-appealed only the Rule 206(4)-1(a)(5) findings.

We find that RJLC violated, and Lucia aided and

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[2] The ALJ found that Section 204 did not apply to Respondents' backtests because they did not concern the performance of specific managed accounts or specific securities recommendations.

abetted and caused RJLC's violations of, Advisers Act Sections 206(1), 206(2), and 206(4), and Rule 206(4)-1(a)(5). For these violations, we impose the same sanctions as the ALJ imposed. We base our findings on an independent review of the record, except with respect to those findings not challenged on appeal.

Finally, we reject Respondents' contention that the administrative hearing was an unconstitutional procedure because the Commission ALJ who presided over this matter was not appointed in accordance with the Appointments Clause of the U.S. Constitution.[3] As we explain below, a Commission ALJ is a "mere employee"—not an "officer"—and thus the appointment of a Commission ALJ is not covered by the Clause.

II. Facts

At the center of this proceeding is a slideshow presentation[4] that Respondents projected onto a screen at seminars to pitch their BOM strategy to prospective clients; in particular, the proceeding focuses on the slideshow's discussion of two "backtests" to prove the efficacy of Respondents' BOM strategy during difficult historical market periods. At issue is, (i) whether Respondents led prospective clients to believe that they had performed backtests, as the Division claims, or hypothetical illustrations, as Respondents claim; (ii) if the former, whether Respondents had actually performed backtests; and (iii) if Respondents had not actually performed backtests but nevertheless led prospective clients to believe that they had

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[3] *See* U.S. Const. art. II, § 2, cl. 2.

[4] Lucia has been presenting a variation of the slideshow since around 2000. Lucia used the version of the slideshow discussed herein from around 2009 to 2010.

done so, whether there is a difference between Respondents' purported backtest results and the results that actual backtests would have shown.

We begin by summarizing the undisputed facts surrounding the slideshow presentation and Respondents' calculations in support thereof. We then present the conflicting evidence regarding Respondents' assertions during that presentation, including the meaning of the term "backtest" and the parties' expert evidence on the effect that using historical inflation and REIT rates, including advisory fees, and rebucketizing would have had on Respondents' "backtest" calculations.

A. The BOM seminar presentation

The BOM strategy, which Lucia developed, generally advocates using safe portfolio assets for retirement income before depleting riskier assets, thereby giving riskier assets time to grow.[5] From approximately 2000 through 2011, Lucia pitched the BOM strategy to prospective RJLC clients at seminars across the United States.[6] As noted, Lucia used a slideshow that he projected onto a screen during his

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[5] The Division has not argued that the BOM strategy itself violates the securities laws.

[6] Lucia estimates that he presented the BOM strategy at about forty seminars per year, and to over 50,000 total seminar attendees, the purpose of which was to generate leads for RJLC. To that end, Respondents gave prospective clients response cards to complete at the seminars to indicate their interest in a complimentary financial planning consultation with an RJLC advisor. Lucia also promoted the BOM strategy on his nationally syndicated radio show, *The Ray Lucia Show*, and in three books on investing for retirement that he authored: *Buckets of Money: How to Retire in Comfort and Safety* (2004); *Ready . . . Set . . . Retire!* (2007); and *The Buckets of Money Retirement Solution: The Ultimate Guide to Income for Life* (2010).

seminar presentations.[7] The slideshow consisted of four parts:[8] (i) a general discussion of investment risks and strategies; (ii) a description of various hypothetical couples following strategies purportedly inferior to BOM; (iii) a description of the BOM strategy and how it would work for a hypothetical couple dubbed the "Bold Bucketeers"; and (iv) the 1966 and 1973 backtests at issue in this proceeding.[9]

1. The three hypothetical couples

After beginning the presentation with a lengthy discussion of various investment risks and strategies, Lucia described three hypothetical couples to illustrate problems caused by following strategies purportedly inferior to BOM. For the illustrations, each couple was assumed to have a $1 million nest egg to invest with the goals of leaving $1 million to their chil-

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[7] Lucia also used a similar version of the slideshow in pitching the BOM strategy in a video posted on RJLC's website on February 16, 2009 (the "Webinar"). The OIP does not mention the Webinar, but Respondents introduced it as evidence of what Lucia told prospective clients at the seminars.

[8] It is undisputed that Lucia was responsible for, and approved the content of, the slideshow.

[9] As noted, Respondents contend that they did not lead prospective clients to believe that they had performed backtests. But because Respondents used the word "backtest" in their seminars to describe their analysis of how the BOM strategy would have fared for a model portfolio from 1966 to 2003 and 1973 to 1994, we also use that word to describe their analysis. That word is also appropriate because, as discussed below, we find that Respondents led prospective clients to believe that they had performed backtests.

dren and producing $60,000 in annual retirement income.[10]

a. Conservative Campbells

The slideshow stated that one couple, dubbed the "Conservative Campbells," invested their $1 million nest egg in conservative investments such as CDs, bond funds, and individual bonds. Their portfolio produced a hypothetical 6% annual return but the Campbells also withdrew $60,000 per year for income (*i.e.*, 6% of the portfolio). The slideshow stated that the problem with this strategy is that, assuming 3% annual inflation, the purchasing power of the Campbells' $60,000 annual income would diminish to $44,644 in ten years, $33,221 in twenty years, and $24,719 in thirty years. As a result, if the Campbells died after thirty years, their children would inherit $1 million but with the equivalent purchasing power of $411,987 from the initial retirement date. And if the Campbells indexed their $60,000 annual income to 3% assumed inflation every six years, they would run through their nest egg within twenty-seven years.[11]

b. High Rolling Hendersons

The slideshow stated that a second couple, dubbed the "High Rolling Hendersons," invested their $1 million nest egg in stocks because they believed that,

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[10] Most slides for this portion of the presentation included disclaimers that "[t]his is a hypothetical illustration and is not representative of an actual investment."

[11] For indexing, the slideshow clarified that the couple would increase the amount they withdrew for annual income every six years assuming 3% inflation for each of the six years. Thus, the Conservative Campbells would withdraw $60,000 each year for six years, and then $71,500 each year for another six years, and so on.

since stocks average 10% in annual return, in thirty years their portfolio would be worth $4,203,320 after withdrawing $60,000 for annual inflation indexed income. But the Hendersons would have problems if they retired at the beginning of a big bear market. For example, the slideshow stated that if the Hendersons had retired on January 1, 1973, the beginning of a two-year period when the market declined by 41.13%, they would have exhausted their portfolio in seventeen years based on the performance of the S&P 500 for that period assuming that they had withdrawn $60,000 in annual income indexed by 3% annual inflation.[12]

c. Balanced Buttafuccos

The slideshow stated that a third couple, dubbed the "Balanced Buttafuccos," invested their $1 million nest egg 40% in bonds and 60% in stocks. The slides stated that the Buttafuccos have a "better more 'balanced' approach" than the Campbells and Hendersons. But when their strategy is "backtested" with a retirement date starting on January 1, 1973, the Buttafuccos are shown to have exhausted their retirement portfolio in twenty-one years. The slides stated that the "backtest" was based on the performance of the S&P 500, an assumed 6% constant bond return, and the Buttafuccos having withdrawn $60,000 annual income for the first six years, $71,500 annual income for the next six years, and $85,500 annual income for another six years.[13]

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[12] Like the Campbells, the Hendersons were assumed to have increased the amount they withdrew for income every six years assuming 3% inflation for each of the six years.

[13] Although not stated explicitly in the Buttafucco slides, the annual income for each six year period in Respondents'

2. Description of the BOM strategy

The slideshow then described how the BOM strategy would work for a fourth hypothetical couple, dubbed the "Bold Bucketeers," who also had a $1 million nest egg.[14] In following the BOM strategy, the Bold Bucketeers divided their portfolio into three "buckets" of assets: Bucket #1 held "[s]afe money in a self-depleting bucket aimed at providing income to live on for" six years (*e.g.*, CDs, T-bills, bonds); Bucket #2 held "[s]afe, or moderately safe, money aimed at replacing Bucket #1 with inflation indexed income for the next period (6 years)" (*e.g.*, bonds, fixed annuities); and Bucket #3 held "[h]igher risk money invested for long term growth potential" (*e.g.*, stocks and REITs).[15]

In illustrating the BOM strategy, the slideshow stated that Bucket #1 was assumed to have a 4% return, Bucket #2 a 5.5% return, and Bucket #3 a 10% stock return and 7.75% REIT dividend return, and that $60,000 income was indexed by an "[a]ssumed 3% inflation" every six years.[16] At the end of the initial six year period, Bucket #1 had been fully depleted for income, at which point the assets from Bucket #2 were used for income for the next six years. After twelve

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"backtest" increased assuming 3% inflation for each of the six years (*i.e.*, $60,000 with 3% annual inflation after six years equals about $71,500).

[14] Most slides for this portion of the slideshow included disclaimers that "[r]ates of return are hypothetical in nature and are for illustrative purposes only."

[15] REITs issue equity and/or debt securities to raise capital to purchase and manage income-producing real estate, such as apartment complexes, shopping centers, and office buildings.

[16] The slideshow disclaimed, inter alia, that "[i]nvesting in real estate and [REITs] involve special risk, such as: limited liquidity and demand for real property . . . ."

years, Bucket #2 had also been fully depleted for income. But the long term assets in Bucket #3 had grown to a value of $1.4 million which, the slideshow stated, was then "[r]e-[b]ucketize[d] for another 12 years."[17]

3. Backtest slides

Finally, Lucia discussed the backtests at issue here, beginning with the backtest from 1973 to 1994, and concluding with the backtest from 1966 to 2003.

a. 1973 backtest slides

The slideshow introduced the 1973 backtest by asking, "But Can Buckets Stand Up To The Test Of The '73/'74 Grizzly Bear?" The next slide, titled "Back Tested Buckets," set forth the assumptions for the backtest, including that (i) the Bold Bucketeers invested their $1 million portfolio beginning on January 1, 1973; (ii) the portfolio was 20% invested in REITs; (iii) "actual treasury rates of return" were used "to calculate fixed income/bond returns"; (iv) "actual S&P 500 returns" were used "to calculate growth returns"; and (v) the Bold Bucketeers withdrew annual income of $60,000 from 1973 to 1978, $71,500 from 1979 to 1984, $85,500 from 1985 to 1990, and $96,000 from 1991 to 1994.[18] The slideshow concluded that the Bold

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[17] "Rebucketization" meant that portions of the assets in Bucket #3 would be reallocated to Buckets #1 and #2 after their assets had been fully depleted for income.

[18] The slides did not state the inflation or REIT rates used in the 1973 backtest or whether advisory fees, such as those charged by RJLC, were factored into the 1973 backtest. Lucia testified that annual income was indexed by 3% inflation every six years for the period of 1973 to 1990, but that Respondents made an error in calculating 3% inflation indexed income for the final period of 1991 to 1994. Respondents' expert, John Hekman,

Bucketeers' portfolio would have been worth $1,544,789 by 1994, the same point in time when the Balanced Buttafuccos' portfolio would have been worth $0.[19]

b. 1966 backtest slides

The slideshow introduced the 1966 backtest by asking, "What would have happened if you retired in 1966"?[20] The slideshow then compared 1966 backtests that Respondents calculated for three different portfolios: (i) a version of the Balanced Buttafuccos' portfolio;[21] (ii) a version of the Bold Bucketeers' portfolio without REITs; and (iii) a version of the Bold Bucketeers' portfolio with REITs. The slideshow stated that, for the 1966 backtests: (i) the "examples are based on actual market returns for the period(s) listed"; (ii) "[b]ond returns are based on US Treasury returns"; (iii) "[s]tock returns are based on S&P 500 returns"; (iv) "REIT returns are based on a 7% annual return"; and (v) "[i]nflation is based at 3% annual."[22]

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calculated that 3% inflation indexed income for that period would have been $102,092, not $96,000.

[19] The slides for the 1973 backtest included a disclaimer that "[r]ates of return are hypothetical in nature and are for illustrative purposes only."

[20] In the Webinar, Lucia introduced the slides by stating that he "did a backtest" for his "friend," Ben Stein, who had asked him this question concerning how the BOM strategy would have fared during the market stagnation of 1966 to 1982, a period when the Dow Jones Industrial Average began and ended at around 1,000 points. Stein is an actor, writer, and economic commentator, who spoke at some of Respondents' seminars.

[21] The slides for the 1966 backtests did not mention the Balanced Buttafuccos, but the first portfolio backtested used the same balanced portfolio approach (60% stocks, 40% bonds).

[22] The slides did not state whether advisory fees were factored into the backtests. Also, unlike earlier slides, the 1966 backtest

For the version of the Balanced Buttafuccos' portfolio, the slideshow stated that the $1 million beginning balance was invested 60% in stocks and 40% in bonds, from which $50,000 annual income was withdrawn on a pro rata basis. The slides concluded that, by 2003, the portfolio would have been worth $30,000 with $0 remaining for annual income.

The slideshow then stated that when the BOM strategy was applied to the same $1 million portfolio invested 60% in stocks and 40% in bonds (*i.e.*, Bold Bucketeers without REITs), the $50,000 annual income was withdrawn from bonds first rather than pro rata. As a result, by 2003, the portfolio would have been worth $1.2 million with $150,000 for annual income.

Finally, the slideshow stated that when REITs were added, the $1 million portfolio following the BOM strategy became split 40% in stocks, 40% in bonds, and 20% in REITs (*i.e.*, Bold Bucketeers with REITs), and the $50,000 annual income was withdrawn from bonds and REITs first.[23] The slideshow concluded that, by 2003, the portfolio would have been worth $4.7 million with $150,000 for annual income.

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slides did not include disclaimers. But in the Webinar, Lucia stated: "[L]et's pretend that from that point forward [*i.e.*, 1966], inflation was three percent. We know it was more. But we wouldn't have known that at the time." Lucia testified that he presented the backtest assumptions the same way in the seminars and Webinar.

[23] Lucia clarified in the Webinar that income is initially drained from the REIT "dividend yield" and bonds, and that the REIT itself is liquidated at a later point for income. Lucia referred in the Webinar to the REIT investment for the 1966 backtest as "direct ownership in real estate."

B. Respondents' actual backtest calculations

1. 1973 backtest calculations

Before the hearing, Respondents produced two spreadsheets that they claimed to have used in calculating the 1966 and 1973 backtests. But during the hearing, Respondents admitted that they did not actually use the spreadsheet they produced for the 1973 backtest to perform that backtest and that the spreadsheet included some assumptions that differed from their backtest. Respondents also admitted that they have no other documentary support for the 1973 backtest.

During the hearing, Lucia also asserted that the slideshow misstated the assumptions used for the 1973 backtest.[24] Lucia testified that rather than using actual S&P 500 returns and treasury returns for the entire twenty-one year period of the 1973 backtest (as presented in the slideshow), Respondents used those returns for only the first two years and then used a flat 10% stock return and 6% bond return for the remaining years. Lucia testified that he neglected to correct the error during his seminar presentations.[25]

But using assumptions similar to those that Lucia testified Respondents actually used in performing the 1973 backtest, Respondents' expert, John Hekman,

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[24] Lucia testified that he personally "did some of the work early on" for the 1973 backtest but that it was completed by an RJLC employee.

[25] Respondents also concede that the 1973 backtest did not include advisory fees or rebucketize the stock investments after bonds and REITs were drained for income. As noted above, this information was not included in the slides for the 1973 backtest.

was unable to replicate the 1973 backtest result presented in the slideshow.[26] Hekman calculated that, by 1994, the Bold Bucketeers' portfolio would have been worth $507,194, an amount substantially lower than the $1,544,789 claimed in the slideshow. Respondents offered no evidence related to this discrepancy or otherwise explained it. It is therefore unclear how Respondents arrived at $1,544,789.

2. 1966 backtest calculations

As noted, Respondents also produced a spreadsheet that they claimed to have used in calculating the 1966 backtest. Respondents specifically used that spreadsheet in calculating the 1966 backtest of the version of the Bold Bucketeers' portfolio with REITs.[27] Respondents did not produce any documentary support for the other two 1966 backtests.[28]

The spreadsheet shows that the backtest to which

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[26] Hekman, who holds a Ph.D. in economics, is a managing director at FTI Consulting, a firm that provides consulting and expert testimony regarding financial matters. Hekman assumed a 6% bond rate, actual S&P 500 returns for the first two years, 10% stock returns for the remaining years, a 5% annual increase in REIT principal, and a REIT dividend rate ranging between approximately 6.6% and 7.76% per year. Hekman also adjusted the Bold Bucketeers' initial $60,000 annual income by 3% annual inflation every six years (*e.g.*, $60,000 for the first six years, $71,500 for the next six years, etc.), and did not deduct advisory fees or rebucketize the portfolio.

[27] RJLC's Director of Financial Planning, Richard Plum, testified that he performed the 1966 backtest calculations in 2004 at Lucia's request. Lucia testified that he designed the 1966 backtest.

[28] Plum testified that he created spreadsheets for the 1966 backtests of the Balanced Buttafuccos' portfolio and the Bold Bucketeers' portfolio without REITs, but Respondents did not produce these spreadsheets to the Division.

it was applicable used the following factors: (i) a $1 million investment beginning on January 1, 1966, split 40% in stocks, 40% in bonds, and 20% in REITs; (ii) $50,000 income withdrawn in 1966, adjusted each subsequent year by 3% inflation; (iii) actual annual S&P 500 returns as a proxy for stock returns; (iv) actual annual treasury returns as a proxy for bond returns; (v) a flat REIT principal of $200,000; and (vi) a flat 7% REIT dividend yield. During the first eleven years of the backtest, income was withdrawn from the $14,000 annual REIT dividend yield (7% on $200,000) with the remaining amount withdrawn from T-bills. At the end of the eleventh year, the $200,000 REIT principal was liquidated and reinvested in T-bills, and then from years twelve through fifteen the remainder of the T-bill investment was drained for income. Thereafter, from 1981 through 2003, the entire Bold Bucketeers' portfolio remained in stocks rather than being rebucketized. No advisory fees were factored into the backtest.[29]

C. The parties' experts agree that Respondents did not perform actual backtests.

Respondents' expert, Hekman, and the Division's expert, Steven Grenadier,[30] agreed that a backtest uses data from a specific historical period to evaluate

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[29] The spreadsheet Respondents produced as empirical evidence of the 1973 backtest used the same assumptions as the 1966 backtest spreadsheet, except that it began on January 1, 1973, rather than January 1, 1966, and assumed that an initial $60,000 rather than $50,000 was needed for annual income, with that amount adjusted each subsequent year by 3% inflation.

[30] Grenadier is a Professor of financial economics at Stanford University.

how an investment strategy would have actually performed during that period.[31] Both experts also agreed that, based on their understanding of the term, the slideshow did not present the results of actual backtests.[32] Grenadier opined that Respondents did not conduct backtests because they used assumed rather than historical inflation and REIT rates, and did not include transaction costs for implementing the BOM strategy.[33] Grenadier also concluded that, by not rebucketizing, Respondents' backtest spreadsheets "concentrate[d] assets in a manner inconsistent with the [BOM] portfolio allocation strategy as outlined in the presentation."

Nonetheless, Respondents disputed that there is an established definition of "backtest" and introduced evidence that, they claimed, showed that it is standard in the financial planning industry to use assumed rates in backtests. Lucia testified that, in the financial planning industry, backtests routinely use "not

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[31] Respondents' chief compliance officer, Theresa Ochs, also testified that a backtest needs to use accurate historical data to provide an accurate indication of how a strategy may have performed in the past.

[32] Hekman also testified that he understood from reviewing the slideshow that it did not purport to present the results of actual backtests.

[33] Respondents' other expert, Kevin T. Gannon, also testified that he would not "use a hypothetical rate of return in a backtest" because he would use actual data in a backtest. Gannon, a Certified Public Accountant, is a managing director and president of Stanger & Co., a real estate investment banking firm.

only averages, for example, inflation, but also . . . hypothetical other investment returns . . . ."[34] As an example, Respondents introduced a brochure issued by American Funds (a large mutual fund house), which used a 4% assumed inflation rate for a backtest from 1961 to 2010. Lucia testified that in addition to American Funds, "there are dozens of variable annuity companies and software companies that do the same thing."

But other than the American Funds' brochure and Lucia's testimony, Respondents did not introduce any evidence of companies using assumed rather than historical data in backtests. To the contrary, Respondents introduced into evidence brochures from Fidelity Investments and Financial Engines Income+ reporting the results of backtests that appear to have used historical stock, bond, and inflation rates.

Respondents also claimed that the American Funds brochure was an example of an industry practice not to include fees in backtests. But it is unclear from the brochure if the two backtests discussed therein included fees. The brochure does not mention fees for the first backtest but it implies that the second backtest included fees by stating that the results "are at net asset value."[35] Also, although not mentioned by Respondents as an example of industry practice con-

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[34] Plum similarly testified that the financial planning industry has always used a mixture of "historical return rates" and "hypothetical assumed annual inflation rate[s]" in backtests.

[35] "Net asset value" is "[t]he market value of a share in a mutual fund, computed by deducting any liabilities of the fund from its total assets and dividing the difference by the number of outstanding fund shares." Black's Law Dictionary 1061 (7th ed. 1999).

cerning fees, the backtest in the Financial Engines Income+ brochure discussed above included fees, and the Fidelity brochure discussed above disclosed that fees were not included in its backtest.

D. The difference between Respondents' purported backtest results and what actual backtests would have shown

The Division's expert, Grenadier, analyzed the two spreadsheets Respondents produced as empirical evidence of the 1966 and 1973 backtests.[36] He concluded that the spreadsheets "use[d] 'important and inaccurate assumptions about inflation, investment returns and liquidity, and implementation costs that significantly affect the results and produce misleading information." Grenadier reran the calculations in the spreadsheets "[s]ubstituting actual, historical data," and produced the results discussed below showing "relatively lower ending portfolio balances than what is reflected in the presentation and spreadsheets, or portfolios that are entirely depleted resulting in substantial unmet income needs." Respondents introduced evidence, including testimony from their expert witnesses, challenging some but not all of Grenadier's

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[36] While, as noted above, Respondents admitted that they mistakenly produced the 1973 backtest spreadsheet, Grenadier's analysis of it is still relevant because it contains assumptions similar to those Respondents claimed to have used in the 1973 backtest. It differs only in that it used actual S&P 500 returns and treasury returns for the length of the backtest rather than 10% stock and 6% bond returns after the first two years, and that it adjusted the amount withdrawn for income by 3% inflation each year rather than by six year increments (*i.e.*, $60,000 for the first six years, $71,500 for the next six years, etc.).

findings.[37]

1. The effect from using historical inflation rates

Grenadier found that the backtest spreadsheets were significantly impacted by using a fixed and assumed 3% inflation rate rather than historical inflation for each of the years considered because many high inflation years occurred early in the backtest periods. Grenadier found that relatively higher inflation as measured by the Consumer Price Index ("CPI"),[38] such as the double-digit inflation of the late 1970s to early 1980s, would have caused the Bold Bucketeers' portfolios to deplete their assets faster in the early years "to have withdrawals that ke[pt] up with inflation," and as a result they would have had "less portfolio later to accumulate returns to consume on."[39]

Grenadier found that by substituting annual historical inflation rates as measured by CPI-U for Respondents' fixed 3% rate, the revised 1966 backtest spreadsheet shows the BOM portfolio being "fully depleted by 1986" and the revised 1973 backtest spreadsheet shows the BOM portfolio being "fully depleted

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[37] Respondents also introduced evidence to show that their assumed 3% inflation and 7% REIT dividend rates were reasonable to use in hypothetical illustrations. But this evidence is irrelevant because, as we find below, Respondents led prospective clients to believe that they performed backtests and not hypothetical illustrations, and backtests use historical and not assumed data.

[38] CPI measures inflation and is maintained by the Bureau of Labor Statistics. Grenadier specifically used CPI-U, which is a category of CPI measuring inflation for urban consumers.

[39] CPI-U was 11.3% in 1979, 13.5% in 1980, and 10.3% in 1981. Lucia agreed that investors would have experienced double digit inflation during this period.

by 1989."[40]

Respondents' expert, Hekman, countered that CPI-U overstated inflation for two reasons. First, Hekman stated that a 1996 report issued by a commission appointed by the Senate Finance Committee (the "Boskin Commission"), and a subsequent paper issued ten years later by a former commission member (Robert Gordon), found that CPI-U had been overstating increases in the annual cost of living. Hekman stated that, based on those findings, CPI-U is "too high by an average of 1.2% per year through 1996 and 1.0% thereafter." Second, Hekman stated that "the most realistic inflation rate for retirees is one that accounts for [their] declining pattern of spending," and concluded that an additional 2% should be deducted from annual CPI-U on top of the corrections suggested by the Boskin Commission and Gordon.

Based on those downward adjustments to CPI-U, Hekman ran two recalculations of the 1966 backtest spreadsheet. In the first, Hekman found that by substituting annual CPI-U adjusted by the Boskin Commission corrections (*i.e.*, annual CPI-U minus 1.2% through 1996 and 1.0% thereafter) for Respondents' fixed 3% rate, the 1966 backtest spreadsheet shows the BOM portfolio running out of money in 1994. In the second, Hekman found that by reducing annual CPI-U by an additional 2% on top of the Boskin Commission corrections to account for reduced retiree spending and substituting that data for Respondents' 3% rate, the 1966 backtest spreadsheet shows the

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[40] Lucia testified that he does not dispute that, if historical inflation as measured by CPI-U had been used in the 1966 or 1973 backtest spreadsheets, it would have resulted in the model BOM portfolios being fully depleted before the end of the backtest periods.

BOM portfolio increasing to a value of over $6.6 million by 2003.

While Grenadier agreed that retirees over sixty-five tend to spend less money than non-retirees, he testified that "has nothing whatsoever to do with inflation." Grenadier testified that to account for any decrease in spending in the 1966 backtest spreadsheet, the assumed $50,000 per year income—and not inflation—should be decreased.

2. The effect from using historical REIT rates of return

Respondents acknowledge that, from 1966 to 1971, REITs were not readily available to investors. For this reason, Grenadier was unable to factor historical REIT returns into the 1966 backtest spreadsheet for that period. For the period after 1971, Grenadier also found it significant in analyzing both the 1966 and 1973 backtest spreadsheets, that Respondents' slideshow did not make clear whether Respondents were using assumed returns from publicly traded REITs, public non-traded REITs, or private REITs.[41]

For the first category, Grenadier found that substituting annual historical returns for publicly traded REITs as measured by the National Association of Real Estate Investment Trusts ("NAREIT") All REIT Index[42] back through 1972 into the 1966 backtest

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[41] Publicly traded REITs file with the Commission and have their shares traded on an exchange, public non-traded REITs file with the Commission but do not trade their shares on an exchange, and private REITs neither file with the Commission nor trade their shares on an exchange.

[42] NAREIT began maintaining indices of annual returns for publicly traded REITs in 1972.

spreadsheet (leaving all other data unchanged) resulted "in a total investment in REITs of only $85,646 at the time the REIT investment [was] liquidated, as compared to $200,000 in the original spreadsheet, and total assets of only $1.3 million at the end of 2003, as compared to $4.7 million in the original spreadsheet."[43] Grenadier also found that substituting such data into the 1973 backtest spreadsheet (leaving all other data unchanged) resulted "in a total investment in REITs of only $134,031 at the time the REIT investment [was] liquidated, as compared to $200,000 in the original spreadsheet, and total assets of only $2.8 million at the end of 2003, as compared to $4.1 million in the original spreadsheet."[44]

For the last two categories, Grenadier found that, to the extent Respondents were using public non-traded or private REITs, the backtest spreadsheets should have considered "the ability and potential cost to liquidate the REIT investment."[45] As noted, Respondents' 1966 backtest spreadsheet liquidated the

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[43] Gannon testified that a more reasonable index to use for historical publicly traded REIT returns is the NAREIT Equity REIT Trust Index ("NAREIT Equity Index"), which includes REITs invested only in real estate equity, because equity REITs were the subject of Respondents' backtests. Grenadier testified that he used the NAREIT All REIT Index because it was unclear whether the REIT investment in the backtests was limited to only equity or mortgage REITs. In any event, Gannon did not analyze, and it is unclear from the record, what effect substituting data from the NAREIT Equity Index into the spreadsheets would have had on the spreadsheet results.

[44] The 1973 backtest in the slideshow ended in 1994, but the 1973 backtest spreadsheet was calculated through 2003.

[45] While publicly traded REITs are highly liquid, non-traded REITs are substantially less liquid because they generally have a minimum required holding period after which redemption

$200,000 REIT principal at the end of the eleventh year after T-bills had been drained down to a level at which they could no longer cover income.[46] In doing so, Grenadier found that the spreadsheets "ignore that redemption of private and/or public non-traded REITs may be difficult and costly."

Gannon did not offer expert testimony concerning the effect on the backtests from using annual historical REIT returns.[47]

3. The effect from deducting advisory fees

Grenadier found that if a strategy has implementation costs, like BOM, it is important when backtesting the strategy to include such costs because they "may reduce, and at times eliminate, the benefits of [the] strategy." Grenadier found that, by assuming zero implementation costs, Respondents' backtest spreadsheets overstated "the ending portfolio balances." In particular, Grenadier found that the backtest spreadsheets should have included "cost[s] associated with an investment in the S&P 500 Index," T-bills, and REITs. By incorporating representative mutual fund fees on the stock portfolio into the spreadsheets (leaving all other data unchanged), Grenadier found that the value of the model portfolio dropped in the (i) 1966 backtest spreadsheet to $2.5 million from $4.7 million by 2003; and (ii) 1973 backtest spreadsheet to $3.1 million from $4.1 million

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characteristics vary by REIT. Some non-traded REITs may allow investors to redeem shares once a quarter, subject to certain requirements; others link redemption to a required liquidity event after a fixed amount of time.

[46] The 1973 backtest spreadsheet liquidated the $200,000 REIT principal at the end of the ninth year.

[47] Respondents retained Gannon to opine on the use of a hypothetical 7% REIT rate of return in hypothetical illustrations.

by 2003.[48]

Respondents offered no expert testimony on the issue of costs. And Lucia testified that he knew fees can significantly reduce a portfolio's returns over time.

4. The effect from rebucketizing

Grenadier concluded that the 1966 and 1973 backtest spreadsheets were inconsistent with the BOM strategy presented in the seminars because they did not rebucketize after T-bills and REITs had been exhausted for income and instead left all assets in stocks. Grenadier noted that for both spreadsheets, "the average S&P 500 return over the time period in which the portfolios [were] entirely invested in stocks [was] higher than the average for the time period in which the portfolios [were] also invested in other assets besides stocks." In addition, although not directly addressed by Grenadier, from the record evidence it appears that, for the period in the 1966 backtest spreadsheet that the model portfolio was entirely invested in stocks (1981 to 2003), the average S&P 500 return was substantially higher than T-bill returns and about equivalent to publicly traded REIT returns as measured by the NAREIT Equity Index. And from 1986 to 2003, when the BOM portfolio in the 1973 backtest spreadsheet was entirely invested in stocks, the average S&P 500 return was substantially higher than T-bill returns and slightly higher than publicly traded REIT returns as measured by the NAREIT Equity Index.

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[48] Grenadier used the average equity mutual fund fee of 0.8% for 1966 to 1970 and 1% for 1971 to 1977. Thereafter he used 0.05% to match the fee charged by the least expensive mutual fund (Vanguard 500 Fund) for that period.

Respondents conceded that they did not rebucketize the 1966 or 1973 backtests and offered no expert testimony to support their approach. Lucia also admitted at the hearing that the BOM strategy does not advocate that investors leave their assets in stocks after draining other assets for income,[49] and stated in the Webinar that investors (i) should not "put a hundred percent of [their] money into the stock market" and (ii) should "never drain that stock portfolio for income."[50] Lucia also testified that he was aware that if the 1966 backtest spreadsheet had been rebucketized, the model portfolio would have ended up with significantly less money.

Lucia testified, however, that seminar attendees would have known that the backtests were not rebucketized. While Lucia acknowledged that the slideshow made no explicit disclosure that the backtests did not rebucketize, he testified that seminar attendees would nonetheless have known that the backtests were not rebucketized because he explained to them that rebalancing is not always necessary. Lucia testified that, during the seminars, he drew out a bucket strategy by hand to show that the stock bucket does not have to be rebalanced and mentioned an academic article by Sandeep Singh, Ph.D., CFA, and John Spitzer, Ph.D., finding that retirees "could live off of the dividends and the income stream from the equity portfolio and an annuity contract" without rebalancing.

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[49] Plum similarly testified that "[p]utting a hundred percent into stocks" is "not a Buckets of Money strategy," and that RJLC did not believe investors "should be a hundred percent in stock."

[50] Lucia also wrote in a letter to RJLC clients dated October 9, 2008, that he "would never – NEVER – advocate being 100% invested in stocks."

No evidence corroborates Lucia's testimony on this point. To the contrary, the Webinar shows that Lucia diagramed the bucket strategy and mentioned the Singh/Spitzer article to criticize the "rebalancing method," which involves withdrawing income from a retirement portfolio on a pro rata basis and rebalancing the entire portfolio annually. Lucia stated in the Webinar that the Singh/Spitzer article found that the "rebalancing method" is inferior to the BOM strategy. Lucia did not state in the Webinar that rebalancing was unnecessary in following the BOM strategy after Buckets #1 and #2 had been depleted.

E. Investor testimony

Two RJLC clients who had attended Respondents' seminars, Richard R. DeSipio and Dennis Wayne Chisholm, testified at the hearing.[51] DeSipio testified that, for the period of market stagnation starting in 1966, he understood that the BOM strategy was "backtested or checked out and that it held up relatively well compared to the other three investment programs," and that the 1966 backtest used "actual performance data" and "average inflation" that accurately reflected inflation during that historical era. DeSipio testified that he thought the 1966 backtest showed "that over a longer projected period of time, certainly for '66 going forward, that [the BOM strategy] held up under the various market conditions that occurred over the years."

DeSipio testified that if he knew the inflation rate used in the 1966 backtest was not the historical rate

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[51] DeSipio attended a seminar in Philadelphia, Pennsylvania in 2007, and Chisholm attended a seminar in Portland, Oregon in 2007.

he would have "come to question" the backtest's results, and that it would have been an important factor for him to know that the model BOM portfolio would have been reduced to $0 in twenty years if Respondents had used historical inflation rates and deducted advisory fees in the backtest. DeSipio also testified that he does not recall Lucia disclosing that the 1966 backtest did not rebucketize the model BOM portfolio. DeSipio testified that he would not want his entire retirement portfolio to be invested in stocks, as was done here in backtesting the BOM strategy without rebucketizing.

Chisholm testified that he understood from the seminar that a bear market "would not be an issue" for the model BOM portfolio "because [the strategy] was a proven method of investing, that it had been backtested," and "would do well over good times as well as bad times." Chisholm testified that in deciding whether to become an RJLC client, it would have been important to him to know that the model BOM portfolio would have been exhausted in sixteen years if the 1973 backtest had used historical inflation. Chisholm testified that "it would have lessened his confidence in" the backtests if he had known that 3% inflation was not the historical rate.

Chisholm testified that Lucia did not say anything at the seminar about the availability of REITs in 1966 and that he would have wanted to know if REITs were not readily available in evaluating the value of the 1966 backtest. Chisholm testified that Lucia emphasized during the seminar that portfolio assets be rebucketized but did not disclose that the 1966 and 1973 backtests did not rebucketize. Chisholm testified that he assumed that the backtests rebucketized and that he would have liked to have known that they did not

rebucketize. Like DeSipio, Chisholm testified that he would not want his entire retirement portfolio invested in stocks.

III. Discussion

A. RJLC willfully violated Advisers Act Sections 206(1), (2), and (4).

1. Legal Standard

Advisers Act Sections 206(1), (2), and (4) make it unlawful for an investment adviser, by jurisdictional means,[52] "directly or indirectly: (1) to employ an device scheme or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; . . . or (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative."[53] There is significant overlap among Sections 206(1),

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[52] Respondents do not dispute that RJLC was an investment adviser or that the Commission has jurisdiction by virtue of their actions in interstate commerce. Respondents also do not dispute that they acted willfully, which is shown where a person intends to commit an act that constitutes a violation; it does not require that the actor "also be aware that he is violating one of the Rules or Acts." *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (internal quotation marks and citation omitted).

[53] 15 U.S.C. § 80b-6(1), (2), & (4). Section 206(4) further provides that "[t]he Commission shall, for the purposes of this paragraph (4) by rules and regulations define . . . such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." *Id.* § 80b-6(4). But to violate Section 206(4), there is no precondition that one of its underlying rules, such as Rule 206(4)-1, have been violated. *See Warwick Capital Mgmt., Inc.*, Advisers Act Release No. 2694, 2008 WL 149127, at *8-9 (Jan. 16, 2008) (finding a violation of Section 206(4) without an associated rule violation).

(2), and (4),[54] the boundaries of which do not need to be delineated here. For purposes of this proceeding, it is sufficient to note that all three sections encompass the making of fraudulent misstatements of material fact and omissions of material fact necessary to make statements made not misleading.[55]

Scienter, which can be established through recklessness, is necessary to violate Section 206(1).[56] Negligence is sufficient to violate Sections 206(2) and (4).[57] Lucia's conduct and his scienter or negligence are imputed to RJLC.[58]

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[54] *Cf. John P. Flannery*, Advisers Act Release No. 3981, 2014 WL 7145625, at *14 (Dec. 15, 2014) (finding the subsections of Exchange Act Rule 10b-5 "to overlap," with each encompassing, among other things, making fraudulent misstatements of material fact), *appeal docketed*, No. 15-1080 (1st Cir. Jan. 16, 2015); *see also SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) ("Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation enacted for the purpose of avoiding frauds, not technically and restrictively, but flexibly to effectuate its remedial purposes." (internal quotation omitted)).

[55] *Warwick Capital Mgmt.*, 2008 WL 149127, at *8-9 (finding that an investment adviser violated Sections 206(1), (2), and (4) by making false and misleading statements about its assets and performance).

[56] *Vernazza v. SEC*, 327 F.3d 851, 860 (9th Cir. 2003); *SEC v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992).

[57] *Steadman*, 967 F.2d at 643 n.5, 647.

[58] *A.J. White & Co. v. SEC*, 556 F.2d 619, 624 (1st Cir. 1977) (holding that a firm "can act only through its agents, and is accountable for the actions of its responsible officers"); *Warwick Capital Mgmt.*, 2008 WL 149127, at *9 n.33 ("A company's scienter is imputed from that of the individuals controlling it.").

2. Respondents made fraudulent statements and omissions in the backtest slides.

Respondents' backtest slides were misleading because: (1) they falsely stated that Respondents had backtested a model BOM portfolio; (2) they stated that backtesting proved that such a portfolio would have withstood two difficult historical market periods when actual backtesting would have shown the opposite; and (3) even using Respondents' flawed assumptions, they overstated the 1973 backtest result by over $1 million.

First, Respondents conveyed to prospective clients that they had performed actual backtests of a model portfolio following the BOM strategy. In addition to using the word "backtest" to describe their analysis, Respondents' slideshow introduced the 1966 backtest by asking, "What would have happened if you retired in 1966[?]," and introduced the 1973 backtest by asking, "Can Buckets Stand Up To The Test Of The '73/'74 Grizzly Bear?" Because of such statements, the two seminar attendees who testified at the hearing, DeSipio and Chisholm, justifiably believed that Respondents had performed backtests.

But Respondents had not actually performed backtests. The parties' experts agreed that backtests use historical data. And instead of using historical data, Respondents' backtests used assumed inflation and REIT rates. Also, it was blatantly untrue for Respondents to claim that their backtests followed the BOM strategy when they did not rebucketize the model portfolio and instead left all of its assets in stocks after safer assets had been drained for income.

The BOM strategy included rebucketization and forbade investing all portfolio assets in stocks.[59]

Second, the purported results of Respondents' backtests were misleading. Had Respondents performed actual backtests beginning in 1966 and 1973 by using historical inflation and REIT rates and rebucketizing, their model portfolio would have been shown to have exhausted its assets rather than having grown in value to $4.7 million and $1,544,789, respectively, by the end of the backtest periods.

In particular, Respondents' use of a flat 3% inflation rate made the backtest results misleading because historical inflation as measured by CPI-U was substantially higher during the backtest periods. Because annual CPI-U reached double digits in the late 1970s and early 1980s, inflation adjusted annual income would have substantially increased early in the backtest periods, thereby substantially decreasing principal and ultimately causing the model portfolio to be exhausted before the backtests ended. As discussed above, this result would not change for the 1966 backtest even using Hekman's downward adjustment to CPI-U based on the Boskin Commission corrections.[60]

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[59] As noted above, the ALJ also found that Respondents' statements about the backtests were misleading because Respondents did not inform prospective clients that the backtests did not deduct advisory fees. Given our other findings, which amply support liability and the sanctions imposed, we have determined not to reach this additional basis for liability.

[60] Hekman recalculated only the 1966 backtest using the Boskin Commission corrections; he did not also recalculate the 1973 backtest. In addition, Respondents' contention, supported by Hekman's conclusion, that CPI-U should be further reduced

In addition, Respondents' use of a flat 7% REIT dividend rate on a constant $200,000 REIT principal made the backtest results misleading because it was higher than historical REIT rates of return. As Grenadier demonstrated without contradiction, substituting data from the NAREIT All REIT Index back through 1972 resulted in REIT principal dropping to $85,646 in Respondents' 1966 backtest spreadsheet and $134,031 in Respondents' 1973 backtest spreadsheet, and lower valued portfolios as a consequence.[61] The 1966 backtest was further inflated by Respondents' use of entirely fictitious REIT rates for 1966 to 1971, a period when REITs were generally unavailable to investors.

Also, Respondents' failure to rebucketize the backtests inflated their results because, during the period when the model BOM portfolio was fully invested in stocks, S&P 500 returns were substantially higher than T-bill returns and about equivalent to publicly traded REIT returns. A rebucketized model BOM portfolio would have been invested in all three assets, not just stocks.[62]

Third, Respondents overstated the 1973 backtest result by over $1 million even using their assumptions. Respondents concede that they have no documentary support for the $1,544,789 result they presented to seminar attendees, and their expert, using

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to account for reduced retiree spending is not persuasive because, as Grenadier observed, it unjustifiably conflates spending levels with inflation.

[61] Respondents did not demonstrate that Grenadier's calculations would be materially different using the NAREIT Equity Index instead of the NAREIT All REIT Index.

[62] Lucia also admitted in testimony that not rebucketizing caused the backtests to show higher portfolio returns.

assumptions similar to those Respondents claim to have used, concluded that the model BOM portfolio would have been worth only $507,194 at the end of the 1973 backtest. Thus, Respondents either fabricated the 1973 backtest result or presented it to seminar attendees without ensuring its accuracy.

3. Respondents' fraudulent statements and omissions were material.

For a misleading statement to be material, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[63] It would have been significant to a reasonable investor in considering whether to become an RJLC client or implement the BOM strategy to know that: (i) Respondents' purported backtests did not use historical inflation or REIT rates or even follow the BOM strategy by rebucketizing; (ii) actual backtests beginning in 1966 and 1973 would have shown the model portfolio to have been exhausted by the 1980s rather than providing decades of payouts with an increase in residual principal; and (iii) Respondents presented a result for the 1973 backtest that was over $1 million higher than even their flawed assumptions would have shown.

Our conclusion is supported by testimony from prospective clients who attended Respondents' seminars. DeSipio and Chisholm testified that they would have found it important to know that Respondents' backtests did not use historical inflation and that actual backtests using historical data would have shown the model portfolio to have exhausted its assets.

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[63] *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

Chisholm also testified that he would have wanted to know that the backtests did not rebucketize and that REITs were not readily available in 1966. And DeSipio testified that that he would not want his entire portfolio to be invested in stocks, as was done here by not rebucketizing the backtests.

4. Respondents made the fraudulent misstatements and omissions with scienter.

Respondents acted at least recklessly.[64] Lucia designed the backtests and was responsible for the backtest slides. In approving and using the backtest slides, it was Lucia's decision to tell seminar attendees that he had backtested the BOM strategy to show how a portfolio implementing it in the past would have performed over historical time periods with specific negative market performance. But Lucia knew that the backtests were not based on historical data and did not rebucketize, and therefore knew or must have known of the risk of misleading prospective clients to believe that Respondents had performed actual backtests of a model BOM portfolio. Indeed, because Lucia admitted that the BOM strategy does not advocate keeping all portfolio assets in stocks, he knew or must have known that it was untrue to claim that the backtests followed the BOM strategy.

Also, Lucia knew or must have known that the backtest results he presented were misleading. Lucia

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[64] The recklessness required to violate Section 206(1) "is not merely a heightened form of ordinary negligence; it is an 'extreme departure from the standards of ordinary care, . . . which presents a danger of misleading buyers or sellers that is either known to the [respondent] or is so obvious that the actor must have been aware of it.'" *Steadman*, 967 F.2d at 641-2 (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1045 (7th Cir. 1977)).

knew that: (i) actual inflation was higher than 3% early in the backtests and fluctuated annually; (ii) REITs did not produce flat 7% dividend rates on flat principal; and (iii) not rebucketizing caused the backtests to show higher portfolio returns.

Finally, Lucia acted recklessly, at the very least, in presenting the 1973 backtest results without ensuring their accuracy. As discussed above, Respondents provided no support for their 1973 backtest and Hekman was unable to replicate its results. Lucia also admitted in testimony that the 1973 backtest slides misstated the methodology Respondents purportedly used for the backtest.

B. Lucia willfully aided and abetted and caused RJLC's violations of Advisers Act Sections 206(1), 206(2), and 206(4).

To establish aiding and abetting liability, the Commission must find: (i) a primary violation of the securities laws by RJLC; (ii) that Lucia substantially assisted RJLC's primary violation; and (iii) that Lucia provided such assistance with the requisite scienter.[65] The scienter requirement may be satisfied by evidence that Lucia knew of or recklessly disregarded the wrongdoing and his role in furthering it.[66]

Because the primary violations of Advisers Act Sections 206(1), 206(2), and 206(4) are premised on the imputation of Lucia's conduct and scienter to RJLC for the reasons discussed above, we find that Lucia satisfies the elements for aiding and abetting liability. Lucia substantially assisted RJLC's primary

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[65] *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004); *Eric J. Brown*, Advisers Act Release No. 3376, 2012 WL 625874, at *11 (Feb. 27, 2012).

[66] *Brown*, 2012 WL 625874, at *11.

violations because he designed the backtests, was responsible for the backtest slides, and made the material misstatements about the backtests to seminar attendees. Lucia provided such assistance with scienter because he knew or must have known that the statements he made about the backtests to seminar attendees were misleading. Because we find that Lucia aided and abetted RJLC's primary violations, "he necessarily was a cause of the violations."[67]

C. RJLC willfully violated, and Lucia willfully aided and abetted and caused RJLC's violation of, Advisers Act Section 206(4) and Rule 206(4)-1(a)(5) thereunder.

Advisers Act Rule 206(4)-1(a)(5) provides that it constitutes a fraudulent act, practice, or course of business within the meaning of Section 206(4) for an investment adviser "directly or indirectly, to publish, circulate, or distribute any advertisement . . . which contains any untrue statement of a material fact, or which is otherwise false or misleading."[68] The Rule defines "advertisement" to include "any notice, circular, letter *or other written communication* addressed to more than one person . . . which offers . . . investment advisory service[s] with regard to securities."[69] As the Ninth Circuit found, "[t]he term 'advertisement' is broadly defined in Rule 206(4)-1(b)" and includes "[i]nvestment advisory material which promotes advisory services for the purpose of inducing potential clients to subscribe to those services."[70]

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[67] *Zion Capital Mgmt. LLC*, Advisers Act Release No. 2200, 2003 WL 22926822, at *7 (Dec. 11, 2003).

[68] 17 C.F.R. § 275.206(4)-1(a)(5).

[69] 17 C.F.R. § 275.206(4)-1(b) (emphasis added).

[70] *C.R. Richmond & Co.*, 565 F.2d at 1104.

Respondents urge us to apply the same reading of Rule 206(4)-1 as did the ALJ, who found that their slideshow presentation was not an "advertisement" because it did not qualify as a "written communication" under Rule 206(4)-1(b).[71] The ALJ based his finding on precedent that he understood to hold that a "written communication" includes "only traditional media, including books, newsletters, and newspaper and magazine advertisements."[72] And because "[t]here is no evidence that slideshow printouts or synopses thereof were handed out to seminar participants or otherwise published in printed or handwritten form at the seminars," the ALJ found that the slideshow presentation was not a "'written communication' as that term has been interpreted."[73]

But none of the cases cited by the ALJ, nor any other case, has held that only traditional media qualifies as a "written communication" under Rule 206(4)-1(b). To the contrary, the cases cited by the ALJ merely found that a "written communication" *includes* newsletters, newspaper advertisements, and books.[74] They did not exclusively define those words.

The plain language of Rule 206(4)-1(b) also does not limit a "written communication" to traditional media or require that a "written communication" be in

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[71] *Raymond J. Lucia Cos.*, 2013 WL 6384274, at *50-51.

[72] *Id.* at *51. The ALJ cited the following cases as precedent: *SEC v. Suter*, No. 81-3865, 1983 WL 1287, at *11-12 (N.D. Ill. Feb. 11, 1983), *aff'd*, 732 F.2d 1294 (7th Cir. 1984); *SEC v. Lindsey-Holman Co.*, No. 78-54-MAC, 1978 WL 1129, at *2-3 (M.D. Ga. Aug. 6, 1978); *C.R. Richmond & Co.*, 565 F.2d at 1104.

[73] *Raymond J. Lucia Cos.*, 2013 WL 6384274, at *51.

[74] *Suter*, 1983 WL 1287, at *11-12; *Lindsey-Holman Co.*, 1978 WL 1129, at *2-3; *C.R. Richmond & Co.*, 565 F.2d at 1104.

hard-copy rather than electronic or projected form.[75] The Rule's only limitations on what qualifies as a "written communication" are that it be "written"[76] and a "communication."[77] Both of those limitations are met here. There is no question that the slideshow was written. And its projection onto a screen along with Lucia's presentation of its contents was a communication to seminar attendees. Thus, the slideshow was a "written communication" within the meaning of Rule 206(4)-1(b).

The slideshow also meets the two additional requirements of the Rule's broad definition of "advertisement." First, the slideshow was addressed to more than one person—typically to an audience of one hun-

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[75] Although not specifically interpreting the phrase, "written communication," we have previously advised that, under Rule 206(4)-1, "electronically disseminated advertisements are subject to the same prohibitions against misleading disclosure as advertisements in paper." *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers*, Advisers Act Release No. 1562, 1996 WL 242059, at *6 (May 9, 1996); *see also id.* at *2 n.4 ("[T]he antifraud provisions of . . . section 206 of the Advisers Act and the rules thereunder, apply to information delivered and communications transmitted electronically, to the same extent as they apply to information delivered in paper form.").

[76] At the time we adopted Rule 206(4)-1 in 1961, Webster's Third New International Dictionary defined "written" as the past participle of "write," which it in turn defined as, *inter alia*, (i) "to set forth in written language . . . reveal, describe, treat of, or depict by means of words"; and (ii) "to form or produce letters, words, or sentences with a pen, pencil, or machine." Webster's Third New Int'l Dictionary 2640-41 (1961).

[77] Webster's Third New International Dictionary defined "communication" as, *inter alia*, (i) "the act or action of imparting or transmitting"; (ii) "facts or information communicated"; and (iii) "interchange of thoughts or opinions." *Id.* at 460.

dred to five hundred people. Second, the slideshow offered RJLC's investment advisory services with regard to securities. Indeed, Respondents used the slideshow presentation to generate leads for RJLC. To that end, Respondents handed out response cards for seminar attendees to complete if they wanted to meet with an RJLC advisor. Lucia also repeatedly offered RJLC's services throughout the Webinar presentation of the slideshow. And Respondents treated the slideshow as marketing and advertising material requiring review by RJLC's broker-dealers.

The remaining elements of Rule 206(4)-1 have also been satisfied. By projecting the slideshow onto a screen and presenting its contents during the seminars, Lucia published, circulated, and distributed it.[78] And as set forth above, the slideshow contained untrue statements of material fact and was misleading.

Accordingly, we find that RJLC willfully violated Section 206(4) on the additional ground that its conduct constitutes a fraudulent act, practice, or course of business as defined in Rule 206(4)-1(a)(5). And because that primary violation is premised on the imputation of Lucia's conduct and scienter to RJLC as discussed above, we find that Lucia willfully aided and abetted and caused RJLC's violation of Section 206(4) and Rule 206(4)-1(a)(5).

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[78] Webster's Third New International Dictionary defined "publish" as, *inter alia*: (i) "to declare publicly"; (ii) "to impart or acknowledge to one or more persons"; and (iii) "to place before the public (as through a mass medium)." Webster's at 1837. It defined "circulate" as, *inter alia*, (i) "to spread widely"; and (ii) "to cause to pass from person to person and [usually] to become widely known." *Id.* at 409. And it defined "distribute" as, *inter alia*, "to give out or deliver esp. to the members of a group." *Id.* at 660.

D. Respondents' arguments against liability lack merit.

1. Respondents contend that they did not mislead prospective clients.

Respondents claim that they explicitly told seminar attendees, through both the slides and the actual words spoken by Lucia, that they were presenting hypothetical illustrations using hypothetical assumptions. Respondents claim that the slides themselves "specifically and repeatedly explained that '[r]ates of return are hypothetical in nature and are for illustrative purposes only'" and that "[t]his is a hypothetical illustration and is not representative of an actual investment." And Respondents claim that Lucia, in presenting the slides, "expressly informed seminar attendees that he was using *hypothetical, pretend, assumed* rates of return."[79]

We find that such statements did not change the overall impression that Respondents had performed backtests showing how the BOM strategy would have

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[79] Respondents also contend that seminar attendees would have understood that the inflation and REIT rates used were hypothetical because: (i) the attendees were "comprised primarily of retirees and near-retirees who had lived through periods of high inflation, [and no reasonable attendee] would have understood the 3% annual inflation rate . . . to be based on actual historical inflation"; and (ii) "a reasonable investor understands that in reality return rates fluctuate, and respondents' illustrations, rather than being based on real-life data, incorporated an assumed constant rate of return." But DeSipio and Chisholm did not make such assumptions. To the contrary, they justifiably understood from Respondents' presentation that Respondents had used historical rates in their backtests.

performed during the two historical periods.[80] In addition to using the word "backtest," Respondents' slideshow introduced the 1966 backtest by asking, "What would have happened if you retired in 1966[?]," and introduced the 1973 backtest by asking, "Can Buckets Stand Up To The Test Of The '73/'74 Grizzly Bear?" And the two seminar attendees who testified understood from Lucia's presentation that Respondents had performed backtests showing that the BOM strategy could increase a portfolio's value during the two historical periods.[81]

Moreover, regardless of Respondents' disclaimers about hypothetical rates, Respondents misled seminar attendees by not rebucketizing the 1966 and 1973 backtests. In other words, it would have been just as misleading for Respondents not to rebucketize if they

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[80] *Cf. C.R. Richmond & Co.*, 565 F.2d at 1106-07 (finding that advertisements were "deceptive and misleading in their overall effect," in violation of Advisers Act Section 206(4) and Rule 206(4)-1, "even though [it might be argued that] when narrowly and literally read, no single statement of a material fact was false" (quoting *Spear & Staff, Inc.*, Advisers Act Release No. 188, 1965 WL 88746, at *3 (1965))); *see also id.* at 1105 ("[C]onduct with respect to [Rule 206(4)-1] is to be measured from the viewpoint of a person unskilled and unsophisticated in investment matters, . . . and the terms 'fraud' and 'deceit' are used in a flexible and non-technical sense to effectuate the [Advisers] Act's remedial purposes.").

[81] Respondents also contend that Lucia referenced "direct ownership in real estate" when discussing the period from 1966 to 1971 in the backtest. But the 1966 backtest slides specifically stated that "*REIT* returns are based on a 7% annual return," and the 1966 backtest spreadsheet referred only to REITs. And Respondents did not clarify during the seminars that REITs were generally unavailable from 1966 to 1971 and that they actually meant "direct ownership in real estate" when discussing that period.

had in fact stated that they were presenting a hypothetical illustration that purportedly followed the BOM strategy as it was for them not to rebucketize what was described as a backtest. Rebucketizing was a key aspect of the BOM strategy, and keeping all assets in stocks—the result of not rebucketizing—contravened the strategy (and substantially inflated the resulting returns). Thus, not rebucketizing made it untrue for Respondents to claim that their model portfolio, whether presented as a "hypothetical illustration" or a backtest, followed the BOM strategy.

Respondents' 1973 backtest results were also false regardless of disclaimers about hypothetical rates. As noted, Respondents' expert did not come within $1 million of the 1973 backtest results using Respondents' own hypothetical inflation rate and other assumptions similar to those that Respondents claim to have used. Consequently, even if Respondents were presenting hypothetical illustrations and not backtests, it was misleading for them to present such grossly inaccurate results.

Respondents contend that the only purpose of the seminar presentation was to compare BOM to three other strategies, and that the Division failed to show that, had Respondents "used historical data rather than hypothetical assumptions . . . [the BOM] strategy would have failed to outperform the other investment strategies illustrated."[82] For example, Respondents assert that they used the same 3% inflation rate for

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[82] Respondents similarly argue that there can be no finding of materiality here because the Division has made no "allegation (much less an evidentiary showing) . . . that, had Mr. Lucia used actual rates of return . . . and 'rebucketized,' his recommended strategy would not have outperformed the alternative approaches illustrated in the seminar."

each of the strategies illustrated and there was no showing that, "under a higher inflation rate, Lucia's strategy would not have nonetheless outperformed the alternatives he illustrated."

We reject this argument because the purpose of the backtest slides was not only to compare strategies but also to show the efficacy of the BOM strategy during difficult historical market periods. Respondents misled seminar attendees to believe that, as Chisholm testified, BOM "was a proven method of investing, that it had been backtested," and "would do well over good times as well as bad times." But actual backtests would have shown that the BOM strategy would not have done well over the two historical "bad times" chosen. And again, regardless of this contention, not rebucketizing the backtests and presenting grossly inaccurate 1973 backtest results made Respondents' representations false and misleading.

Respondents also assert four reasons why their assumptions were reasonable and not used to mislead seminar attendees. First, Respondents contend that they submitted "expert testimony supporting the reasonableness of the assumed inflation rates and REIT return rates used in the illustrations." For example, Hekman "testified that the use of a 3% inflation rate for hypothetical retirement planning calculations is universally recognized," and Gannon "testified that a 7% REIT return rate for 1966-2003 . . . was reasonable and supported by available indices." We reject this argument because Hekman and Gannon made clear that their opinions about the reasonableness of Respondents' inflation and REIT rates did not apply to backtests but rather to hypothetical illustrations, and Respondents led seminar attendees to believe that they had performed backtests.

Second, Respondents contend that it was reasonable not to rebucketize the backtests because to do so "would have been highly speculative" and potentially led to accusations of manipulating rebalancing dates because the "strategy illustrated . . . did not represent an actual portfolio with specific investments, but rather a general approach to diversification," and "[d]eciding when and how to shift asset classes would turn entirely on a client's individualized holdings and the market conditions at the time." We reject this contention because, even if Respondents genuinely held these concerns, it was misleading for them not to disclose to seminar attendees that that the backtest results were inflated because they did not rebucketize. Respondents' contention also seems insincere considering that Respondents had no apparent difficulty or reservation in shifting asset classes in the backtest spreadsheets from REITs to T-bills.

Third, Respondents contend that their assumptions were reasonable because there is no established definition of "backtest" precluding the use of assumed rates. Respondents contend that to base liability here on "a firm definition not found in the securities laws," would violate due process by denying Respondents "fair notice of what conduct is required or proscribed," and be an abuse of discretion by imposing "regulatory changes through litigation" rather than rulemaking. Respondents also contend that "[e]ven if one were to posit that Mr. Lucia misused the term 'backtest,' it cannot be denied that he informed visitors of his seminars exactly how he was using it."

We reject these arguments. In finding liability, we need not define "backtest" in all contexts, we just need to assess its use by Respondents here. That use was in conjunction with other statements that misled

seminar attendees to believe that Respondents had analyzed how a model portfolio would have performed had it implemented the BOM strategy in the past. Respondents never informed attendees that their assumptions would not actually show, as they claimed, whether the model BOM portfolio could "stand up to" the market challenges starting in 1966 or 1973.[83]

Fourth, Respondents contend that their assumptions were reasonable because it was industry practice to use assumed rates in backtests. As an example of that practice, Respondents point to the American Funds brochure "that included multiple illustrations of 'back-testing withdrawal rates,' all using hypothetical (rather than actual) inflation rates over an historical period." But Respondents introduced no expert testimony to establish industry practice, and their own inflation and REIT experts agreed that backtests use historical rates. And while the backtests in the American Funds brochure used an assumed 4% inflation rate, two other brochures in the record, from Fidelity and Financial Engines Income+, reported the results of backtests that appear to have used historical stock, bond, and inflation rates.

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[83] Respondents similarly contend that we would violate due process if we interpreted "written communication" in Rule 206(4)-1 to include their live slideshow presentation, and that "the appropriate way to bring [the rule] up to date is through rulemaking." We also reject this argument because, as discussed above, Rule 206(4)-1 has discernible parameters that gave Respondents fair notice that their conduct fell within its scope. And even if we were applying a new interpretation of the rule, "[i]t is well settled that an agency 'is not precluded from announcing new principles in an adjudicative proceeding. . . .'" *Cassell v. FCC*, 154 F.3d 478, 486 (D.C. Cir. 1998) (quoting *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 294 (1974)).

2. Respondents contend that their statements about the 1966 and 1973 backtests were not material.

Respondents make various other arguments that do not concern the validity of the backtests, but focus more on materiality. Respondents assert that their presentation cannot have been material because they did not recommend or sell securities at the seminars, and it is undisputed that their disclosures to attendees who eventually became Firm clients were "100% complete and accurate." But .liability under Section 206 does not require that the fraudulent conduct be in connection with the offer or sale of securities.[84] To the contrary, Section 206 includes within its scope misrepresentations that are not specific to a client investment decision.[85]

Respondents also contend that they "submitted unrebutted evidence at the hearing showing that after [they] ceased using the illustrations in question once

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[84] *SEC v. Lauer*, No. 03-80612-CIV, 2008 WL 4372896, at *24 (S.D. Fla. Sept. 24, 2008), *aff'd*, 478 F. App'x 550 (11th Cir. 2012); *see also Applicability of the Investment Advisers Act*, Advisers Act Release No. 1092, 1987 WL 112702, at *9 (Oct. 8, 1987) (staff interpretive release stating that the Section 206 provisions "do not refer to dealings in securities but are stated in terms of the effect or potential effect of prohibited conduct on the client").

[85] *See, e.g., SEC v. C.R. Richmond & Co.*, 565 F.2d 1101, 1106 (9th Cir. 1977) (investment adviser violated Section 206 by making misrepresentations in a book and newsletter concerning its investment strategy and the results of a model portfolio); *see also Applicability of the Investment Advisers Act*, 1987 WL 112702, at *9 (staff interpretive release stating that "the Commission has applied Sections 206(1) and (2) in circumstances in which the fraudulent conduct arose out of the investment advisory relationship between an investment adviser and its clients, even though the conduct does not involve a securities transaction").

concerns were raised by the SEC examination staff [in 2010], the response rate of seminar attendees who filled out contact cards requesting to meet with an RJLC adviser did not decline." We find that the response cards are not determinative of materiality because they do not show whether attendees would have expressed interest in the Firm if they had been told that backtests showed the model BOM portfolio exhausting its assets during the two historical periods. This is because Respondents never told the truth about the backtests; they simply stopped using the backtest slides. And even if the response cards were relevant to materiality, Respondents introduced insufficient evidence to establish what the cards showed. Respondents' contention is based solely on vague testimony from Lucia's son that during the periods before and after Respondents stopped using the backtest slides, "basically the same" percentage of seminar attendees who filled out response cards checked a box to meet with a financial advisor.[86]

3. Respondents contend that they cannot have acted with scienter.

Respondents make various arguments that Lucia cannot have acted with scienter, and that he was, at worst, negligent in that his "hypothetical illustrations . . . were inartfully prepared." Respondents contend that Lucia "testified that he subjectively believed his use of the term 'backtest' encompassed the utilization

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[86] Lucia's son testified that based on response card data, from January to June 2010, a period when the slides were used, about 50% of seminar attendees wanted to meet with a financial advisor, and from January to June 2011, when the slides were no longer used, about 47% of seminar attendees wanted to meet with a financial advisor.

of hypothetical information." We reject this self-serving contention because it is contradicted by Lucia's representations to seminar attendees that the backtest slides showed how a portfolio implementing the BOM strategy in 1966 or 1973 would have performed. In other words, our finding of liability does not hinge on Lucia's use of the word "backtest." Lucia made numerous other statements suggesting that the slides reflected historical results, and he knew or must have known that using hypothetical data in the backtests would not reflect historical results.

Respondents also deny any scienter by pointing to "third party review [of the backtest slides] by both the registered broker-dealers who had supervisory oversight" of the Firm,[87] as well as Commission staff in a 2003 examination of the Firm,[88] who never told Respondents "that the slides were in any way misleading." Respondents contend that they therefore were "not aware of red flags suggesting that the slides were misleading." We reject these arguments. First, Respondents were well aware of the facts that rendered the backtest slides misleading for the reasons discussed above, and thus any reliance they placed on third party review would not have been reasonable.[89] Second, there is no evidence that: (i) Respondents

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[87] Respondents' registered broker-dealers, Securities America (from 2002 to 2007) and First Allied (from 2007 to 2011), reviewed RJLC's marketing and advertising material, including the slideshow, before it was distributed publicly.

[88] The examination was conducted by the Division of Investment Management's compliance office, a precursor office to the Commission's Office of Compliance Inspections and Examinations ("OCIE").

[89] *Cf. Flannery*, 2014 WL 7145625, at *33 (rejecting reliance-on-counsel defense, in part, because respondent "was well aware of the facts that rendered the statements at issue misleading").

brought the backtests to the attention of the Commission staff or broker-dealers; (ii) Respondents provided any support for the backtest slides that would have permitted a meaningful review of their content; or (iii) the Commission staff or broker-dealers addressed the backtests with Respondents. Thus, we are not presented with a situation where a third party told Respondents that the backtest slides were not misleading and Respondents relied on that advice. To the contrary, the Commission staff told Respondents in a deficiency letter dated December 12, 2003, that RJLC "should not assume that [its] activities not discussed in this letter are in full compliance with the federal securities laws."

As support for this last contention, Respondents point to *SEC v. Slocum, Gordon, & Co.*, in which the court concluded that the defendant investment adviser could not be found to have intentionally omitted material facts about its account structure (which created a potential conflict of interest by commingling firm and client funds) from its Form ADV in violation of Advisers Act Section 207 and Rule 204-1(c).[90] The court found that it was reasonable for the defendant to believe that its account structure complied with the securities laws because two Commission examinations and annual independent auditor examinations failed to identify issues with it.[91] But *Slocum* is inapposite because the defendant relied on the advice of counsel in structuring its accounts and subsequently brought its account structure to the Commission's attention.[92] Here, there is no evidence that Respondents relied on counsel or brought the backtest slides to the

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[90] 334 F. Supp. 2d 144 (D.R.I. 2004).

[91] *Id.* at 180-82.

[92] *Id.* at 160-61.

Commission's attention.

E. Respondents' Appointments Clause argument lacks merit.

Respondents argue that the ALJ who presided over this matter and issued the initial decision, ALJ Cameron Elliot, was not appointed in a manner consistent with the Appointments Clause of the Constitution.[93] Respondents further claim that, in light of this purported constitutional violation, the proceedings "are themselves invalid and any resulting orders should be vacated." We find that the appointment of Commission ALJs is not subject to the requirements of the Appointments Clause.[94]

Under the Appointments Clause, certain high-

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[93] Congress has empowered "[e]ach agency [to] appoint as many administrative law judges as are necessary," and it has established a comprehensive scheme to govern the details of ALJs' employment in the civil service. 5 U.S.C. §§ 3105, 1101 *et seq.*; *see also* 15 U.S.C. § 78d-1(a) (authorizing the Commission to delegate functions to "an administrative law judge"); Exchange Act Section 4(b), 48 Stat. 885 (original Exchange Act provision authorizing the Commission to appoint "examiners"). The Commission has for many decades relied upon ALJs to prepare initial decisions in its administrative proceedings.

[94] The constitutional claims raised here implicate many "threshold questions" regarding the Commission's rules and practices. *Elgin v. Dep't of Treasury*, 132 S. Ct. 2126, 2140 (2012); *see also Thunder Basin Coal Co. v. Reich*, 510 U.S. 200, 214-15 (1994). In the course of considering the constitutional claims, we address those questions and legal principles. It is important that the Commission have an opportunity to address constitutional issues in the first instance, as it has in the past. *See, e.g.*, *Gary M. Kornman*, Exchange Act Release No. 59403, 2009 WL 367635, at *12 (Feb. 13, 2009) (Double Jeopardy claim); *Vladen Vindman*, Securities Act Release No. 8670, 2006 WL 985308, at *11 & n.60 (Apr. 14, 2006) (Seventh Amendment claim).

level government officials must be appointed in particular ways: "Principal officers" must be appointed by the President (and confirmed by the Senate), while "inferior officers" must be appointed either by the President, the heads of departments, or the courts of law.[95] The great majority of government personnel are neither principal nor inferior officers, but rather "mere employees" whose appointments are not restricted by the Appointments Clause.[96] It is undisputed that ALJ Elliot was not appointed by the President, the head of a department, or a court of law.[97] Respondents therefore contend that his appointment violates the Appointments Clause because, in their view, he should be deemed an inferior officer. The Division counters that he is an employee and thus there was no violation of the Appointments Clause.

Our consideration of this question is guided by the D.C. Circuit's decision in *Landry v. FDIC*, which addressed whether ALJs should be deemed inferior officers or employees.[98] *Landry* held that, for purposes of the Appointments Clause, ALJs at the Federal De-

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[95] The Clause provides that the President "by and with the advice and consent of the Senate, shall appoint . . . officers of the United States . . . but the Congress may by law vest the appointment of such inferior officers, as they think proper, in the President alone, in the courts of law, or in the heads of departments." U.S. Const. art. II, §2, cl. 2.

[96] *Landry v. FDIC*, 204 F.3d 1125, 1134 (D.C. Cir. 2000) (quoting *Freytag v. Commissioner*, 501 U.S. 868, 882 (1991)); *Buckley v. Valeo*, 424 U.S. 1, 126 (1976).

[97] The Commission constitutes the "head of a department" for purposes of the Appointments Clause when its commissioners act collectively. *See Free Enter. Fund v. Public Co. Accounting Oversight Bd.*, 561 U.S. 477, 512-13 (2010).

[98] *Landry*, 204 F.3d at 1130-34.

posit Insurance Corporation ("FDIC") who oversee administrative proceedings to remove bank executives are employees rather than inferior officers. *Landry* explained that the touchstone for determining whether adjudicators are inferior officers is the extent to which they have the power to issue "final decisions."[99] Although ALJs at the FDIC take testimony, conduct trial-like hearings, rule on the admissibility of evidence, have the power to enforce compliance with discovery orders, and issue subpoenas, they "can never render the decision of the FDIC."[100] Instead, they issue only "recommended decisions" which the FDIC Board of Directors reviews *de novo*, and "[f]inal decisions are issued only by the FDIC Board."[101] The ALJs thus function as aides who assist the Board in its duties, not officers who exercise significant authority independent of the Board's supervision. Because ALJs at the FDIC "have no such powers" of "final decision," the D.C. Circuit "conclude[d] that they are not inferior officers."[102]

The mix of duties and powers of the Commission's ALJs are very similar to those of the ALJs at the FDIC. Like the FDIC's ALJs, the Commission's ALJs conduct hearings, take testimony, rule on admissibility of evidence, and issue subpoenas. And like the FDIC's ALJs, the Commission's ALJs do not issue the final decisions that result from such proceedings. Just as the FDIC's ALJs issue only "recommended decisions" that are not final, the Commission's ALJs issue

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[99] *Id.* at 1133-34.

[100] *Id.* at 1133.

[101] *Id.*

[102] *Id.* at 1134.

"initial decisions" that are likewise not final.[103] Respondents may petition us for review of an ALJ's initial decision,[104] and it is our "longstanding practice [to] grant[] virtually all petitions for review."[105] Indeed, we are unaware of any cases which the Commission has not granted a timely petition for review. Absent a petition, we may also choose to review a decision on our own initiative,[106] a course we have followed on a number of occasions.[107] In either case, our rules expressly provide that "the initial decision [of an ALJ]

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[103] *See* 17 C.F.R. § 201.360(a)(1) & (d). We note that the FDIC Board has discretion to "limit the issues to be reviewed to those findings and conclusions to which opposing arguments or exceptions have been filed by the parties." 12 C.F.R. § 308.40(c)(1).

[104] 17 C.F.R. § 201.411(b).

[105] Rules of Practice, Exchange Act Release No. 35833, 1995 WL 368865, at *80-81 (June 9, 1995); *see also* Rules of Practice, Exchange Act Release No. 33163, 1993 WL 468594, at *59 (Nov. 5, 1993) (explaining that we are "unaware of any case in which the Commission has declined to grant a petition for review"). We reiterated this policy in the context of amendments to our Rules of Practice in 2004 that eliminated the filing of oppositions to petitions for review. We deemed such oppositions pointless, "given that the Commission has long had a policy of granting petitions for review, believing that there is a benefit to Commission review when a party takes exception to a decision." Proposed Amendments to the Rules of Practice and Related Provisions, Exchange Act Release No. 48832, 2003 WL 22827684, at *13 (Nov. 23, 2003).

[106] 17 C.F.R. § 201.411(c); *see also* 15 U.S.C. § 78d-1(b) (providing that "the Commission shall retain a discretionary right to review the action of any . . . administrative law judge . . . upon its own initiative or upon petition").

[107] *See, e.g.*, *Dian Min Ma*, Exchange Act Release No. 74887, 2015 WL 2088438, at *1 (May 6, 2015) ("determin[ing] to review the [ALJ's] decision on [our] own initiative," setting aside the initial decision in part, and providing that "as modified," the initial decision "has become the final decision of the Commission"); *Michael Lee Mendenhall*, Exchange Act Release No. 74532, 2015

shall not become final."[108] Even where an aggrieved person fails to file a timely petition for review of an initial decision and we do not order review on our own initiative, our rules provide that "*the Commission* will issue an order that the decision has become final," and it "becomes final" only "upon issuance of the order" by the Commission.[109] Under our rules, no initial decision becomes final simply "on the lapse of time" by operation of law; instead, it is "the Commission's issuance of a finality order" that makes any such decision effective and final.[110] Moreover, as does the FDIC, the

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WL 1247374, at *1 (Mar. 19, 2015) ("determin[ing] *sua sponte* to vacate the [ALJ's] initial decision"); *George C. Kern, Jr.*, Exchange Act Release No. 29356, 1991 WL 284804, at *1 (June 21, 1991) ("On its own initiative, the Commission ordered review of the [ALJ's] initial decision . . . .").

[108] 17 C.F.R. § 201.360(d)(1).

[109] 17 C.F.R. § 201.360(d)(2) (emphasis added). The effect of this rule, which was enacted pursuant to our general rulemaking authority under the securities laws, is that our ALJs' initial decisions (like the FDIC's ALJs' recommended decisions) do not become the final and effective decision of the agency without affirmative action on our part—specifically, our issuance of a finality order. *See, e.g.*, *Goolu, Inc.*, Exchange Act Release No. 71788, 2014 WL 1213742 (Mar. 25, 2014); *L. Rex Andersen, CPA*, Exchange Act Release No. 63209, 2010 WL 42[illegible]161 (Oct. 28, 2010); *David A. Zwick*, Exchange Act Release No. 56826, 2007 WL 4145827 (Nov. 20, 2007). It is not until the issuance of such an order that the Commission's "right to exercise such review [*i.e.*, review of an initial decision on our own initiative] is declined." *See* 15 U.S.C. § 78d-1(c). In short, under our rules, an ALJ's initial decision does not "become[] the decision of the agency without further proceedings," and any theoretical distinction between the potential legal effect of an initial decision as opposed to a recommended decision is immaterial. *Cf.* 5 U.S.C. § 557(b).

[110] Exchange Act Release No. 49412, 2004 WL 503739, *12 (Mar. 12, 2004); *see also* 17 CFR § 201.360(d)(2) (providing that the Commission's "order of finality shall state the date on which sanctions . . . take effect").

Commission reviews its ALJs' decisions *de novo*. Upon review, we "may affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part," any initial decision.[111] And "any procedural errors" made by an ALJ in conducting the hearing "are cured" by our "thorough, *de novo* review of the record."[112] We may also "hear additional evidence" ourselves, and may "make any findings or conclusions that in [our] judgment are proper and on the basis of the record."[113] For this reason, although ALJs may play a significant role in helping to shape the administrative record initially, it is the Commission that ultimately controls the record for review and decides what is in the record. As we have explained before, we have "plenary authority over the course of [our] administrative proceedings and the rulings of [our] law judges—before and after the issuance of the initial decision and irrespective of whether any party has sought relief."[114]

Notwithstanding the direct relevance of *Landry*,

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[111] 17 C.F.R. § 201.411(a); *see also* 5 U.S.C. § 557(b) ("On appeal from or review of the initial decision, the agency has all the powers which it would have in making the initial decision . . . .").

[112] *Heath v. SEC*, 586 F.3d 122, 142 (2d Cir. 2009); *see also, e.g.*, *In the Matter of Anthony Fields*, Exchange Act Release No. 74344, 2015 WL 728005, *20 (Feb. 20, 2015) ("[O]ur de novo review cures any evidentiary error that the law judge may have made.").

[113] 17 C.F.R. §§ 201.411(a), 201.452.

[114] *Michael Lee Mendenhall*, 2015 WL 1247374, at *1. This includes authority over all evidentiary and discovery-related rulings. And the fact that our ALJs may rule on evidentiary matters and discovery issues (subject to our *de novo* review) does not distinguish them from the FDIC's ALJs in *Landry*. *See* 204 F.3d at 1134 (observing that the FDIC's ALJs make rulings on the "admissibility of evidence" and "discovery order[s]").

Respondents claim that the decision should not control here because, in their view, it "was wrongly decided." They claim that *Landry* "is inconsistent with" *Freytag v. Commissioner*, in which the Supreme Court deemed a Tax Court "special trial judge" to be an inferior officer.[115] But, as *Landry* recognized, ALJs are different from those special trial judges.[116] The far greater role and powers of the special trial judges relative to Commission ALJs, in our view, makes *Freytag* inapposite here.

First, unlike the ALJs whose decisions are reviewed *de novo*, the special trial judges made factual findings to which the Tax Court was required to defer, unless clearly erroneous.[117] *Second*, the special trial

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[115] *Freytag*, 501 U.S. at 880-82. Respondents insist that Judge Randolph's concurring opinion in *Landry* had the better reading of *Freytag*. For the reasons given in text, we reject this argument. And in any event, Respondents would not be entitled to relief even under the reasoning of the *Landry* concurrence. Our review of ALJ's decisions—like that performed by the FDIC—is *de novo*; thus, given our "*de novo* review" and our "thorough rejection of [Respondents'] various claims of error" on the merits, Respondents "suffered no prejudice" from the manner of appointment of our ALJs. *Landry*, 204 F.3d at 1144 (Randolph, J., concurring).

[116] *Landry*, 204 F.3d at 1133 (explaining that the special trial judges at issue in *Freytag* exercised "authority . . . not matched by the ALJs. . . .").

[117] *See Landry*, 204 F.3d at 1133. Respondents argue that Commission ALJs exercise significant authority because the Commission accords "considerable weight" to those ALJ credibility findings that are based on witness demeanor. *Kenneth R. Ward*, Exchange Act Release No. 47535, 2003 WL 1447865, at *10 (Mar. 19, 2003), *aff'd*, 75 F. App'x 320 (5th Cir. 2003). We do not view the fact that we accord Commission ALJs deference in the context of demeanor-based credibility determinations to afford our ALJs with the type of authority that would qualify them as inferior officers. *First*, as we have repeatedly made clear, we do not

judges were authorized by statute to "render the [final] decisions of the Tax Court" in significant, fully-litigated proceedings involving declaratory judgments and amounts in controversy below $10,000.[118] As discussed above, our ALJs issue initial decisions that are not final unless the Commission takes some further action. *Third*, the Tax Court (and by extension the court's special tax judges) exercised "a portion of the judicial power of the United States," including the "authority to punish contempts by fine or imprisonment."[119] Commission ALJs, by contrast, do not possess such authority.[120]

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accept such findings "blindly," and we will "disregard explicit determinations of credibility" when our *de novo* review of the record as a whole convinces us that a witness's testimony is credible (or not) or that the weight of the evidence warrants a different finding as to the ultimate facts at issue. *Ward*, 2003 WL 1447865, at *10; *accord Francis V. Lorenzo*, Exchange Act Release No. 74836, 2015 WL 1927763, at *10 n.32 (Apr. 29, 2015); *Ofirfan Mohammed Amanat*, Exchange Act Release No. 54708, 2006 WL 3199181, at *8 n.46 (Nov. 3, 2006); *see also Kay v. FCC*, 396 F.3d 1184, 1189 (D.C. Cir. 2005) ("The law is settled that an agency is not required to adopt the credibility determinations of an administrative law judge."). *Second*, our practice in this regard is no different from the FDIC's and so does not warrant a departure from *Landry*. *Compare [Redacted] Insured State Nonmember Bank*, FDIC-82-73a, 1984 WL 273918, at *5 (June 18, 1984) (stating, "as a general rule," that "the assessment of the credibility of witnesses" by the ALJ is given "deference" by the FDIC) *with Ramon M. Candelaria*, FDIC-95-62e, 1997 WL 211341, at *3-4 (Mar. 11, 1997) (noting that the FDIC's ALJ found respondent to be "entirely credible" but the Board rejected respondent's testimony "in light of the entire record").

[118] *Freytag*, 501 U.S. at 882.

[119] *Id.* at 891.

[120] *See* 17 C.F.R. § 201.180. The Commission's rules provide ALJs with authority to punish contemptuous conduct only in the

Based on the foregoing, we conclude that the mix of duties and powers of our ALJs is similar in all material respects to the duties and role of the FDIC's ALJs in *Landry*.[121] Accordingly, we follow *Landry*,

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following ways. If a person engages in contemptuous conduct before the ALJ during any proceeding, the ALJ may "exclude that person from such hearing or conference, or any portion thereof," or "summarily suspend that person from representing others in the proceeding in which such conduct occurred for the duration, or any portion of the proceeding." *Id.* 201.180(a). Finally, if a party fails to make a required filing or to cure a deficiency with a filing, then a Commission ALJ may enter a default, dismiss the case, decide the particular matter at issue against the person, or prohibit the introduction of evidence or exclude testimony concerning that matter." *Id.* 201.180(c). Any such decision would, of course, be subject to *de novo* Commission review. And while Commission ALJs may issue subpoenas to compel noncompliance, they are powerless to enforce their subpoenas. The Commission itself would need to seek an order from a federal district court to compel compliance. *See* 15 U.S.C. § 78u(c). In this respect, too, our ALJs are akin to the FDIC's ALJs that *Landry* found to be mere employees. *See* 12 C.F.R. §§ 308.25(h), 308.26(c), 308.34(c) (providing that an aggrieved party must apply to a federal district court for enforcement of a subpoena issued by a FDIC ALJ).

[121] Beyond *Landry*, we believe that our ALJs are properly deemed employees (rather than inferior officers) because this is how Congress has chosen to classify them, and that decision is entitled to considerable deference. *See Burnap v. United States*, 252 U.S. 512, 516 (1920). For example, Congress created and placed ALJ positions within the competitive service system, just like most other federal employees. *See infra* footnote 93. Like most other employees, an ALJ who believes that his employing agency has engaged in a prohibited personnel practice can seek redress either through the Office of Special Counsel or the Merit Systems Protection Board. *See* 5 U.S.C. §§ 1204, 1212, 1214, 1215, 1221. And ALJs—like other employees—are subject to reductions-in-force. *See id.* § 7521(b).

and we conclude that our ALJs are not "inferior officers" under the Appointments Clause.[122]

IV. Sanctions

The Division requests that we affirm the sanctions imposed below, including that (i) Lucia be barred from associating with an investment adviser, broker, or dealer; (ii) Respondents' investment adviser registrations be revoked; (iii) Respondents be ordered to cease and desist from further violations of the Advisers Act; and (iv) RJLC pay civil penalties of $250,000 and Lucia pay civil penalties of $50,000. We do so for the following reasons.

A. Bar from associating with an investment adviser, broker, or dealer

We may suspend or bar Lucia from associating with an investment adviser, broker, or dealer under Advisers Act Section 203(f) if we find that (i) he was associated with an investment adviser during the relevant period, (ii) he willfully violated, or willfully aided and abetted the violation of, the Advisers Act or

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[122] We do not find any relevance in the fact that the federal securities laws and our regulations at times refer to ALJs as "officers" or "hearing officers." There is no indication that Congress intended "officers" or "hearing officers" to be synonymous with "Officers of the United States," U.S. Const. art. II, § 2, cl. 2, and the word "officer" in our regulations has no such meaning. We also note in this regard that the Administrative Procedure Act "consistently uses the term 'officer' or the term 'officer, employee, or agent'" to "refer to [agency] staff members." Kenneth Culp Davis, *Separation of Functions in Administrative Agencies*, 61 HARV,. L. REV. 612, 615 & n.11 (1948); *see also* 1 U.S.C. § 1 ("'officer' includes any person authorized by law to perform the duties of the office"). *Cf.* 5 U.S.C. §§ 556, 557 (referring to official who presides over evidentiary hearing as the "presiding employee").

its rules, and (iii) the sanction is in the public interest.[123] In addition, if we find that the latter two elements have been established, we may also suspend or bar Lucia from associating with a broker or dealer under Section 15(b)(6) of the Securities Exchange Act of 1934.[124]

There is no question that Lucia was associated with an investment adviser, and, as discussed above, we find that he willfully aided and abetted and caused RJLC's violations of Advisers Act Sections 206(1), (2), and (4) and Rule 206(4)-1(a)(5). Thus, we must determine whether a bar is in the public interest.

In assessing whether an associational bar would be in the public interest, we consider: the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the respondent's recognition of the wrongful nature of his or her conduct, the sincerity of the respondent's assurances against future violations, and the likelihood that the respondent's occupation will present opportunities for future violations.[125] The remedy is intended to "protect[] the trading public from further harm," not to punish the respondent.[126] Our inquiry is flexible, and no one factor is dispositive.[127]

Lucia's misconduct was egregious. As an invest-

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[123] 15 U.S.C. § 80b-3(f).

[124] 15 U.S.C. § 78o(b)(6)(A)(i).

[125] *See Steadman v. SEC*, 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

[126] *McCarthy v. SEC*, 406 F.3d 179, 188 (2d Cir. 2005).

[127] *Kornman*, 2009 WL 367635, at *11.

ment adviser, Lucia owed fiduciary duties to his prospective clients.[128] Lucia violated those duties, and betrayed the trust and confidence of his prospective clients, by making the material misrepresentations and omissions discussed above. We have repeatedly stated that "conduct that violates the antifraud provisions of the securities laws is especially serious and subject to the severest of sanctions under the securities laws."[129]

Lucia's misconduct was recurrent: he made the material misrepresentations and omissions in the slideshow at dozens of seminars every year during the relevant period. Lucia also acted with a high degree of scienter as he knowingly or recklessly misled prospective clients for the purpose of increasing RJLC's client base and the fees generated therefrom. Thus, Lucia repeatedly and intentionally placed his and RJLC's own interests over those of his prospective clients.

Lucia has not recognized the wrongful nature of his misconduct, and his failure to do so casts doubt on his assurances against future violations. In addition, because Lucia disregarded his fiduciary duties in the past in the manner shown here there is reason to believe that he will disregard them in the future.

Lucia's various arguments do not undermine the need for a bar or argue for a lesser remedy. Lucia contends that the credibility of his assurances and his recognition of wrongdoing are demonstrated by his decision to immediately stop using the backtest slides

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[128] *Capital Gains*, 375 U.S. at 194.

[129] *Marshall E. Melton*, Advisers Act Release No. 2151, 2003 WL 21729839, at *9 (July 25, 2003); *Justin F. Ficken*, Advisers Act Release No. 2803, 2008 WL 4610345, at *3 (Oct. 17, 2008).

and withdraw his books from circulation after receiving the deficiency letter from OCIE on December 17, 2010, that outlined the deficiencies forming the basis of this proceeding.[130] These actions do weigh in Lucia's favor but they do not outweigh the concerns raised by his intentional and recurrent fraud.[131]

Lucia asserts that his occupation will not present opportunities for future violations because he has left the securities industry.[132] Lucia states that he wound

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[130] Lucia argues that his actions are comparable to those at issue in *Steadman*, in which the court vacated an injunction against an investment adviser in part because the alleged violations "were corrected immediately after the SEC notified the appellants that charges were pending." 967 F.2d at 648. But unlike our findings here, the *Steadman* court found that the defendants did not act with scienter and therefore did not violate federal securities antifraud provisions.

[131] *Cf. Kornman*, 2009 WL 367635, at *11 (stating that assurances against future misconduct "are not an absolute guarantee against misconduct in the future"; the Commission weighs them against the other *Steadman* factors in assessing the public interest.).

[132] Lucia claims that he "simply desires to continue serving as an in-demand public speaker, consultant, and media personality on retirement planning and other topics," and invites us to make clear that, if we impose a bar, such activity would not violate the bar. Lucia contends that such work is protected by the publisher exclusion to the definition of "investment adviser" in Advisers Act Section 202(a)(11), 15 U.S.C. § 80b-2(a)(11)(D), and is thus outside the scope of an associational bar. But because of "the inherent difficulty of enumerating every position that [Lucia] could take that would be prohibited by, or consistent with," a bar order, granting Lucia's request would undermine the remedial purpose of imposing a bar. *See James M. Schneider, CPA*, Exchange Act Release No. 69922, 2013 WL 3327751, at *5-6 (July 2, 2013) (order denying request that the Commission clarify that its Rule 102(e) suspension order did not preclude movant from accepting non-accounting positions). In any event, we note that

down RJLC's operations, sold its assets, and withdrew its investment adviser registration. Lucia also states that he is no longer associated with an investment adviser or broker-dealer, no longer holds a license as a registered representative, withdrew his own personal investment adviser registration, and has no intention of ever again being an investment adviser or registered representative of a broker-dealer. He also does not challenge the permanent revocation of his and RJLC's investment adviser registrations. Lucia contends that he has therefore demonstrated that his assurances against future violations are credible and that his occupation will not present opportunities for future violations.

But taking these steps does not ensure that Lucia will not seek to become associated again with an investment adviser, broker, or dealer. And like Lucia's decision to stop using the backtest slides, these steps do not make his assurances sufficient considering that he intentionally and repeatedly misled prospective clients to whom he owed fiduciary duties.[133] Thus, there is a reasonable likelihood that, without a bar, Lucia

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the publisher exclusion concerns only who is considered an investment adviser, and not whether a person is *associated with* an investment adviser. The definition for "person associated with an investment adviser" is set forth in Adviser Act Section 202(a)(17), 15 U.S.C. § 80b-2(a)(17).

[133] Also, according to FINRA's BrokerCheck, Lucia did not end his association with investment adviser RJL Wealth Management, LLC, the successor firm to RJLC, until the initial decision was first issued in July 2013, thus casting further doubt on his intention to not reenter the industry. We may take official notice of this information on BrokerCheck, available at www.finra.org/Investors/ToolsCalculators/BrokerCheck. *See* 17 C.F.R. § 201.323 (rule of practice relating to official notice).

will again threaten the public interest by reassociating with an investment adviser, broker, or dealer.

Lucia asserts that several mitigating factors justify a lesser remedy. He contends that a bar would deter businesses from working with him in his career as a public media personality and therefore "propel[] him towards personal bankruptcy." But "[f]inancial loss to a wrongdoer as a result of his wrongdoing does not mitigate the gravity of his conduct."[134]

Lucia contends that he is a "40-year industry veteran with no disciplinary record." But his lack of previous securities law violations does not outweigh the concern that, for the reasons discussed above, Lucia will pose a continuing danger to investors if a bar is not imposed. Lucia's repeated misconduct for a prolonged period demonstrates that he has a propensity for conduct that would subject the investing public to future harm.

Lucia contends that there are no allegations of misappropriation, investor losses, or complaints by any seminar attendees about the presentation. But the absence of injury to RJLC's clients or prospective clients is not mitigating because our public interest analysis "focus[es] . . . on the welfare of investors generally and the threat one poses to investors and the markets in the future."[135]

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[134] *Kornman*, 2009 WL 367635, at *9 (internal quotation and citation omitted).

[135] *Kornman*, 2009 WL 367635, at *9; *vFinance Invs., Inc.*, Exchange Act Release No. 62448, 2010 WL 2674858, at *17 (July 2, 2010); *see also Christopher A. Lowry*, Advisers Act Release No. 2052, 2002 WL 1997959, at *5 n.21 (Aug. 30, 2002) (finding that respondent's repayment to clients of funds he diverted from them did not "excuse[] his initial misrepresentations"), *aff'd*, 340 F.3d

Lucia argues that the initial decisions in *Corbin Jones*[136] and *Joseph C. Lavin*[137] demonstrate that investor losses are an important consideration. But these cases are inapposite because they involved findings that the respondents' violations were egregious, in part, because they caused investor losses.[138] While the absence of investor injury is not mitigating, its existence may be considered in determining the egregiousness of the respondent's actions.[139] Here, even without investor injury as an aggravating factor, Lucia's misconduct was egregious and a bar is in the public interest.

As an alternative to a bar, Lucia contends that it would be more appropriate to impose a censure and require undertakings such as "retain[ing] a monitor to ensure that any public presentations he makes do not utilize 'backtests' or hypothetical illustrations of relative strategy performance." Lucia contends that such remedies would be more in line with the lesser reme-

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501 (8th Cir. 2003); *James C. Dawson*, Advisers Act Release No. 3057, 2010 WL 2886183, at *3 (July 23, 2010) (barring respondent in part because his "dishonesty in defrauding his clients breached the trust that is the underpinning of the fiduciary relationship, regardless of whether there was any net loss of money to his clients").

[136] Initial Decision Release No. 568, 2014 WL 668853 (Feb. 21, 2014).

[137] Initial Decision Release No. 373, 2009 WL 613543 (March 10, 2009).

[138] *Jones*, 2014 WL 668853, at *4; *Lavin*, 2009 WL 613543, at *5.

[139] *See, e.g., Dawson*, 2010 WL 2886183, at *3 ("[O]ur finding that Dawson's conduct was egregious is based on the nature of the violation itself, not solely on any calculation of financial harm to his clients.").

dies imposed in seven settled Commission proceedings.[140] But we have repeatedly found that the remedies imposed in settled actions are inappropriate comparisons because pragmatic considerations "such as the avoidance of time-and-manpower-consuming adversary proceedings," justify accepting lesser remedies in settlement.[141] In addition, the appropriate remedy depends on the facts and circumstances presented and cannot be determined precisely by comparison with actions taken in other cases.[142] Here, the alternative remedy that Lucia proposes do not provide

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[140] Lucia cites *New England Inv. and Retirement Group, Inc.*, Advisers Act Release No. 3516, 2012 WL 6591597 (Dec. 18, 2012); *Modern Portfolio Mgmt., Inc.*, Advisers Act Release No. 3702, 2013 WL 5740461 (Oct. 23, 2013); *Equitas Capital Advisors, LLC*, Advisers Act Release No. 3704, 2013 WL 5740460 (Oct. 23, 2013); *Independent Fin. Group*, Advisers Act Release No. 1891, 2000 WL 1121531 (Aug. 8, 2000); *William J. Ferry*, Advisers Act Release No. 1747, 1998 WL 487681 (Aug. 19, 1998); *Meridian Inv. Mgmt. Corp.*, Advisers Act Release No. 1779, 1998 WL 898489 (Dec. 28, 1998); *LBS Capital Mgmt., Inc.*, Advisers Act Release No. 1644, 1997 WL 401055 (July 18, 1997).

[141] *Michael C. Pattison, CPA*, Exchange Act Release No. 67900, 2012 WL 4320146, at *11-12 (Sept. 20, 2012) (quoting *Nassar and Co., Inc.*, 47 SEC 20, 26 & n.37 (1978)); *Ficken*, 2008 WL 4610345, at *4. We also note that settlements are not precedent. *Citizens Capital Corp.*, Exchange Act Release No. 67313, 2012 WL 2499350, at *5 n.27 (June 29, 2012). The remedies imposed on Respondents are amply justified by our findings of violations, as discussed.

[142] *Ficken*, 2008 WL 4610345, at *4; *see also Butz v. Glover Livestock Comm'n Co., Inc.*, 411 U.S. 182, 187 (1973) (holding that a sanction imposed within the authority of an administrative agency is "not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases"); *Geiger v. SEC*, 363 F.3d 481, 488 (D.C. Cir. 2004) (holding that, because the "Commission is not obligated to make its sanctions uniform," the court would not compare the sanctions imposed in the case to those imposed in previous cases).

sufficient protection for investors given the nature of his misconduct and the opportunity that continued association with an investment adviser, broker, or dealer would present for future violations.

Accordingly, we find that it is in the public interest to bar Lucia from associating with any investment adviser, broker, or dealer. A bar will prevent Lucia from putting investors at further risk and serve as a deterrent to others from engaging in similar misconduct.

B. Revocation of Respondents' investment adviser registrations

Under Advisers Act Section 203(e), we may suspend or revoke an investment adviser's registration if we find that (i) the investment adviser, or any person associated with it, willfully violated, or willfully aided and abetted the violation of, any provision of the Advisers Act and (ii) the sanction is in the public interest.[143] We consider the same public interest factors discussed above for determining whether to revoke an investment adviser's registration.[144]

Lucia states in his brief that "he makes no challenge to . . . ordering the registrations of [Respondents] as investment advisers permanently revoked." The evidence amply supports such revocation, for the reasons discussed above, as being necessary to protect the public interest.[145]

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[143] 15 U.S.C. § 80b-3(e).

[144] *See Sherwin Brown*, Advisers Act Release No. 3217, 2011 WL 2433279, at *6 (June 17, 2011).

[145] Again, Lucia's conduct and level of intent are imputed to RJLC.

C. Cease-and-desist orders

Advisers Act Section 203(k) authorizes us to issue cease-and-desist orders for violations of the Advisers Act.[146] Such orders must be in the public interest, which we determine by looking to whether there is some risk of future violation.[147] The risk "need not be very great" and is ordinarily established by a single past violation absent evidence to the contrary.[148] We also consider whether other factors demonstrate a risk of future violations, including the factors discussed above concerning Lucia's bar as well as whether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought.[149] This inquiry is flexible, and no single factor is dispositive.[150]

Here, Respondents' violations, the egregiousness of their misconduct, and the other public interest factors discussed above establish a risk of future violations. Accordingly, we find that it is in the public interest to order Respondents to cease and desist from committing or causing any violations or future violations of Advisers Act Sections 206(1), 206(2), and 206(4) and Rule 206(4)-1.

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[146] 15 U.S.C. § 80b-3(k).

[147] *Robert L. Burns*, Advisers Act Release No. 3260, 2011 WL 3407859, at *8 n.34 (Aug. 5, 2011).

[148] *KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 WL 47245, at *24 (Jan. 19, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002).

[149] *Id.* at *26.

[150] *Id.*

D. Civil penalties

We may impose civil penalties under Advisers Act Section 203(i) if we find that Respondents willfully violated the Advisers Act and such penalties are in the public interest.[151] Both factors are satisfied here. Respondents repeatedly made fraudulent misstatements and omissions in willful violation of the Advisers Act and their fiduciary duties. Their conduct was egregious and thus warrants the imposition of penalties as a deterrent to Respondents and others against committing similar violations. Such considerations are not outweighed by Respondents' clean disciplinary history or the lack of evidence concerning investor loss or unjust enrichment.

Also, because Respondents' violations involved fraud and were in reckless disregard of a regulatory requirement, we find that second-tier penalties are warranted.[152] Therefore, because the amounts imposed by the ALJ ($250,000 upon RJLC and $50,000

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[151] 15 U.S.C. § 80b-3(i). In determining whether penalties are in the public interest, we consider: (i) whether the act or omission involved fraud; (ii) whether the act or omission resulted in harm to others; (iii) the extent to which any person was unjustly enriched; (iv) whether the individual has committed previous violations; (v) the need to deter such person and others from committing violations; and (vi) such other matters as justice may require. *Id.*

[152] Section 203(i) establishes a three-tier system for calculating penalties: (i) first-tier penalties are permissible for securities law violations; (ii) second-tier penalties are permissible for securities law violations involving "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement"; and (iii) third-tier penalties are permissible for violations that satisfy the second-tier penalty requirements and "directly or indirectly resulted in substantial losses or created significant risk of sub-

upon Lucia) are within the permissible second-tier range,[153] and are in the public interest, we grant the Division's request and impose those same amounts upon Respondents.[154]

Respondents contend that penalties are unwarranted against RJLC because it has no assets or operations, is no longer registered as an investment adviser, and is a dormant corporate shell. Respondents also contend that imposing an uncollectable penalty against RJLC will prejudice Lucia without any benefit to the public interest. These contentions are meritless. If RJLC lacked the ability to pay penalties, it

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stantial losses to other persons or resulted in substantial pecuniary gain to the person who committed the act or omission." *Id.*; 17 C.F.R. § 201.1004.

[153] The maximum second-tier penalty the Commission could impose for a single act of misconduct is $375,000 for RJLC and $75,000 for Lucia. 17 C.F.R. § 201.1004 & Pt. 201, Subpt. E, Tbl. IV.

[154] Although the amounts imposed by the ALJ are within the second-tier range, he categorized them as third-tier penalties. We find that this categorization was unwarranted because the Division did not establish: (i) that Respondents' clients or prospective clients suffered any losses or were at significant risk of suffering substantial losses or (ii) whether Respondents' gain from the fraud was substantial. For the latter consideration, while the Division introduced evidence showing that Respondents' business was profitable, it did not demonstrate the extent to which Respondents' misconduct was responsible for that profit. In any event, we find that the amounts imposed are warranted as second-tier penalties for the reasons discussed above.

was required under Commission Rule 630(a) to present evidence thereof.[155] It has failed to do so.[156] Respondents also have not explained how Lucia would be prejudiced if we order RJLC to pay penalties.

Accordingly, we find that it is in the public interest to impose second-tier penalties of $250,000 upon RJLC and $50,000 upon Lucia.

An appropriate order will issue.[157]

By the Commission (Chair WHITE and Commissioners AGUILAR and STEIN); Commissioners GALLAGHER and PIWOWAR, dissenting. A dissenting opinion will issue separately.

Brent J. Fields
Secretary

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[155] 17 C.F.R. § 201.630(a).

[156] Respondents also have waived their right to assert the defense of inability to pay because they did not raise the issue before the ALJ. *David Henry Disraeli*, Advisers Act Release No. 2686, 2007 WL 4481515, at *19 (Dec. 21, 2007), *aff'd*, 334 F. App'x 334 (D.C. Cir. 2009).

[157] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 75837 / September 3, 2015

INVESTMENT ADVISERS ACT OF 1940
Release No. 4190 / September 3, 2015

INVESTMENT COMPANY ACT OF 1940
Release No. 31806 / September 3, 2015

Admin. Proc. File No. 3-15006

In the Matter of

RAYMOND J. LUCIA COMPANIES, INC.
and
RAYMOND J. LUCIA, SR.

ORDER IMPOSING REMEDIAL SANCTIONS

On the basis of the Commission's opinion issued this day, it is

ORDERED that Raymond J. Lucia, Sr. be barred from association with any investment adviser, broker, or dealer; and it is further

ORDERED that the investment adviser registrations of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr. are revoked; and it is further

ORDERED that Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr. cease and desist from committing or causing any violations or future violations of Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-1; and it is further

ORDERED that Raymond J. Lucia Companies,

Inc. pay a civil money penalty of $250,000; and it is further

ORDERED that Raymond J. Lucia, Sr. pay a civil money penalty of $50,000.

Payment of the civil money penalty shall be (i) made by United States postal money order, certified check, bank cashier's check, or bank money order; (ii) made payable to the Securities and Exchange Commission; (iii) mailed to Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, 6500 South MacArthur Blvd., Oklahoma City, OK 73169; and (iv) submitted under cover letter that identifies the respondent and the file number of this proceeding.

By the Commission.

Brent J. Fields
Secretary

APPENDIX D

Opinion of Commissioner Gallagher and Commissioner Piwowar, dissenting from the opinion of the Commission

Commissioner Daniel M. Gallagher and Commissioner Michael S. Piwowar

Oct. 2, 2015

The misdeeds of the respondents in this case have been well established.[1] In making pitches for investment advisory services to large audiences on multiple occasions, the respondents touted an approach called "Buckets of Money," a catchy name for a re-balancing strategy. Unfortunately, the Commission majority has taken a relatively straightforward set of facts and needlessly engaged in "rulemaking by opinion." For that reason, we dissent from the majority opinion.

The respondents claimed that their approach was more likely to produce favorable results when compared to a conservative portfolio of 100% bonds, an aggressive portfolio of 100% stocks, and a hybrid portfolio of 60% stocks and 40% bonds. The respondents tried to demonstrate the superiority of their "Buckets of Money" approach using scenarios from 1973, when the stock market dropped significantly for two years, and from 1966, when the Dow Jones Industrial Average stagnated for a sixteen year period, as compared to the three other portfolios.

The problem for the respondents was that (i) they did not actually utilize the "Buckets of Money" approach in determining the results for in the 1973 and 1966 scenarios and (ii) with respect to the 1973 scenario,

they could not even re-construct their supporting calculations. Had the Commission majority simply stopped there, the opinion would have been easy to support.

Instead, the majority opinion creates from whole cloth specific requirements for advertisements that include the word "backtest." Despite the lack of any statutory or regulatory definition of what constitutes a "backtest," the majority opinion finds it fraudulent or deceptive practice if a backtest fails to use actual historical rates — even if the slideshow presentation specifically discloses the use of assumed rates for certain components.

In the context of the respondents' slideshow presentation, the use of the word "backtest" and assumed inflation rates were not misleading. A review of the slideshow reveals that the respondents were making two points: (i) inflation can cause a retiree to exhaust retirement savings; and (ii) stock returns can be volatile and a significant decline in the first year or two of retirement will affect how long retirement savings will last.

To illustrate how inflation can affect retirement savings, the respondents used a 3% assumed inflation rate. The effect of inflation was first presented in connection with the conservative scenario. Using the 3% assumed inflation rate, the respondents created a baseline scenario indicating that the conservative portfolio would be exhausted in 27 years if withdrawals were indexed for inflation.

In contrast, the respondents presented the results of an aggressive portfolio invested 100% in stocks. Using an assumed annual return of 10%, the respondents

stated that the aggressive portfolio would never be exhausted. However, the respondents' slideshow presentation repeatedly cautioned that stock returns can be highly volatile and that a significant decline in stocks during the first year or two of retirement could affect whether retirement savings will be sufficient.

The respondents used the 1973 bear market scenario to show the possible effects of stock market volatility on retirement savings and comparative outcomes among the aggressive, hybrid, and "Buckets of Money" portfolios.[2] Using the 3% assumed inflation rate, the respondents claimed in the 1973 scenario that the aggressive portfolio was exhausted in 17 years and the hybrid portfolio was exhausted in 21 years. On the other hand, the respondents asserted that the "Buckets of Money" portfolio would not run out of funds.[3]

It is appropriate to use a consistent, assumed inflation rate when comparing the results among portfolios. Moreover, we find troubling the majority opinion's holding that, notwithstanding the disclosure that the scenarios were determined using assumed 3% inflation, the slideshow presentation was nonetheless fraudulent because a backtest must use historical inflation rates.

The majority opinion emphasizes the testimony of witnesses at the slideshow presentations who thought that the backtests used actual historical inflation rates. But the test for materiality is an objective, not subjective, test of the reasonable investor. Given the clear disclosure of the inflation rate assumptions in the slideshow presentation, we find that a reasonable investor would not have believed that actual historical rates of inflation were used in the backtests.

Finally, the respondents have raised important issues with respect to whether the administrative law judge[4] overseeing the proceeding was appointed in a manner consistent with the Appointments Clause of the Constitution. Even though the Commission is free to express its views on Constitutional issues, we recognize and believe it is appropriate that Article III federal judges ultimately resolve this issue.[5]

[1] *In the Matter of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr.*, Securities Exchange Act Release No. 75837 (Sept. 3, 2015), available at http://www.sec.gov/litigation/opinions/2015/34-75837.pdf.

[2] The respondents asserted that had a person retired in 1973, stock returns for the next two years declined by 41.13%. The respondents showed other slides analyzing similar effects from 1966, when the Dow Jones Industrial Average began and ended for a sixteen year period at around 1,000 points.

[3] As noted previously, the purported results of the Buckets of Money portfolio for the 1973 scenario were fraudulent, but were fraudulent for reasons unrelated to the use of an assumed rate of inflation.

[4] Before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Commission leadership actively sought from Congress expanded authority to seek monetary penalties against individuals through administrative proceedings. The result was Section 929P of Dodd-Frank. *See* SEC's "Wish List" of 42 Changes It Seeks in the Federal Securities Laws (July 16, 2009), available at http://www.securitiesdocket.com/2009/07/16/sec-s-wish-list-of-42-changes-it-seeks-in-the-federal-securities-laws/ (citing Fox Business reports).

[5] *See* Duka v. SEC, 2015 WL 4940057 (S.D.N.Y. Aug. 3, 2015); Hill v. SEC, 2015 WL 4307088 (N.D. Ga. June 8, 2015).

Modified: Oct. 2, 2015

APPENDIX E

INITIAL DECISION
RELEASE NO. 540
ADMINISTRATIVE
PROCEEDING
FILE NO. 3-15006

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of RAYMOND J. LUCIA COMPANIES, INC. and RAYMOND J. LUCIA, SR.	INITIAL DECISION ON REMAND December 6, 2013

* * *

BEFORE: Cameron Elliot, Administrative Law Judge

SUMMARY

This Initial Decision on Remand supplements the July 8, 2013, Initial Decision in this proceeding, confirms that Respondent Raymond J. Lucia Companies, Inc. (RJLC), violated Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 (Advisers Act) by misrepresenting the validity of purported backtesting in seminars for prospective investors, and that Respondent Raymond J. Lucia, Sr. (Lucia) aided and abetted RJLC's violations of Sections 206(1),

206(2), and 206(4) of the Advisers Act, and bars Lucia from associating with an investment adviser, broker, or dealer, revokes Lucia's and RJLC's investment adviser registrations, imposes a civil penalty of $50,000 on Lucia and $250,000 on RJLC, and orders Lucia and RJLC to cease and desist from further violations of the Advisers Act.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission) issued its Order Instituting Administrative and Cease-and-Desist Proceedings (OIP) on September 5, 2012, pursuant to Section 15(b) of the Securities Exchange Act of 1934 (Exchange Act), Sections 203(e), 203(f), and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act of 1940 (Investment Company Act). Lucia and RJLC filed their Answers on September 19, 2012.[1]

The parties filed their prehearing briefs by November 5, 2012. A hearing was held on November 8-9, 13-14, 19-21, 2012, and December 17-18, 2012, at the Commission's headquarters in Washington, D.C. The admitted exhibits are listed in the Record Index issued by the Secretary of the Commission on April 19, 2013.[2] The Division of Enforcement (Division) and

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[1] Lucia and RJLC filed separate Answers, but they are substantively identical. Lucia and RJLC presented a unified defense and, where appropriate, are referred to collectively as Respondents.

[2] On April 12, 2013, counsel for Respondents offered a Submission of Recent Decision (Submission) to demonstrate the "realities and inherent difficulties in ascertaining the value of REIT shares." The Submission also offered an excerpt of the 2014 Budget of the Federal Government to support their arguments

Lucia thereafter filed post-hearing briefs and post-hearing reply briefs.[3]

On July 8, 2013, I issued an Initial Decision finding that RJLC violated, and Lucia aided and abetted RJLC's violations of, Sections 206(1), 206(2), and 206(4) of the Advisers Act by fraudulent misrepresentations concerning an investment strategy involving Real Estate Investment Trust (REIT) securities. The Commission had alleged three other misrepresentations in the OIP, namely, the use of a misleading inflation rate, failure to deduct fees or disclose that the backtests were not net of fees, and failure to reallocate assets in accordance with the strategy presented, without disclosing that failure. I found in the July 8, 2013, Initial Decision that these additional misrepresentations, even if true, would not have resulted in different sanctions than those imposed for misrepresentations regarding REITs. Accordingly, I declined to analyze the three other misrepresentations alleged in the OIP.

On July 18, 2013, RJLC and Lucia filed a Motion to Correct Manifest Errors of Fact, pursuant to Rule 111(h) of the Commission's Rules of Practice. See 17

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regarding inflation rates. I admitted the decision and excerpt as part of the official record.

[3] Citations to the transcript of the hearing are noted as "Tr. ___.". Citations to Lucia's Answer are noted as "Lucia Answer ___," and to RJLC's Answer as "RJLC Answer ___." Citations to exhibits offered by the Division and Respondents are noted as "Div. Ex. ___." and "Resp. Ex. ___.", respectively. The Division's and Respondents' post-hearing briefs are noted as "Div. Br. ___." and "Resp. Br. ___.", respectively. The Division's and Respondents' post-hearing reply briefs are noted as "Div. Reply ___" and "Resp. Reply ___," respectively. The Division's and Respondents' pre-hearing briefs are noted as "Div. Pr. H Br. ___." and "Resp. Pr. H Br. ___.", respectively.

C.F.R. § 201.111(h). On August 7, 2013, I issued an Order on Motion to Correct Manifest Errors of Fact which updated the Initial Decision to correct certain errors. Those corrections are reflected herein.

On August 8, 2013, the Commission, on its own initiative, remanded the case for findings as to the three additional alleged misrepresentations. Raymond J. Lucia Cos., (Aug. 8, 2013) (unpublished Order Remanding Case for Issuance of Initial Decision Pursuant to Rule of Practice 360) (Remand Order). This Initial Decision on Remand updates the July 8, 2013, Initial Decision by making findings as to the remaining allegations. In accordance with the Remand Order, I have considered the specific facts and circumstances presented by the three additional alleged misrepresentations. The sanction determinations made in the July 8, 2013, Initial Decision remain appropriate, for the reasons explained infra.

B. Summary of Allegations

The instant proceeding concerns alleged misrepresentations of backtested returns of fictional investment portfolios using Lucia and RJLC's proprietary Buckets of Money® (BOM) strategy. OIP, p. 2. The OIP alleges the misleading application of (i) historical inflation rates, (ii) investment adviser fee impact, (iii) returns on REITs, and (iv) reallocation of assets in fictional backtested portfolios utilizing the BOM strategy, in slideshow presentations offered by Lucia and books authored by Lucia, a registered investment adviser, and RJLC, a previously registered investment adviser, located in San Diego, California. OIP, p. 2. The OIP alleges that RJLC violated Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder; Lucia aided and abetted and

caused RJLC's violations of Sections 206(1), 206(2), and 206(4) and Rule 206(4)-1(a)(5) thereunder by knowingly or recklessly misrepresenting the accuracy of the backtested investment portfolios to prospective investment clients; and RJLC violated Section 204 of the Advisers Act and Rule 204-2(a)(16) thereunder by failing to maintain proper books and records. OIP, pp. 9-10.

Lucia and RJLC deny most of the key allegations. Lucia Answer, pp. 3-7; RJLC Answer, pp. 3-7. Lucia and RJLC deny that the BOM slideshow presentations were misleading and deny that their backtests were misleading due to their use of a 3% inflation rate, their failure to consider investment adviser fees, their use of assumed REIT rates, and their failure to reallocate assets after a certain period. Lucia Answer, pp. 3-7; RJLC Answer, pp. 3-7.

II. FINDINGS OF FACT

The findings and conclusions herein are based on the entire record. I applied preponderance of the evidence as the standard of proof. See Steadman v. SEC, 450 U.S. 91, 102 (1981). I have considered and rejected all arguments, proposed findings, and conclusions that are inconsistent with this Initial Decision on Remand.

A. Background

1. Lucia

Lucia, at the time of the OIP, was a 61-year old registered investment adviser and the sole owner of

RJLC. Lucia Answer, pp. 1-2.[4] Lucia began his financial management career in 1974 as an insurance agent with Penn Mutual Insurance Company, which he left in 1991. Tr. 1031. Afterward, Lucia was self-employed for a few months before joining John Hancock as a general agent. Tr. 1033-34. Lucia left John Hancock in 1995 and joined Acacia Life Insurance Company. Tr. 1034. In 1996, Lucia registered with the Commission as an investment adviser, associated with RJLC, which registered as an investment adviser in 2002. RJLC Answer, p. 1; Div. Ex. 2, p. 5; Tr. 1035.

Lucia has hosted the *Ray Lucia Show* on the radio since 1990, and the show became nationally syndicated in 2000. Tr. 1025-26. In 2010, the BIZ Network began televising the *Ray Lucia Show*. Tr. 1025-26. Lucia has authored three books promoting the BOM strategy–Buckets of Money: How to Retire in Comfort and Safety (2004); Ready...Set...Retire! (2007); and The Buckets of Money Retirement Solution: The Ultimate Guide to Income for Life (2010). Lucia also used two websites, www.rjlwm.com and www.raylucia.com, for marketing, and posted some of his seminars on the latter. Tr. 624; Lucia Answer, p. 2.

Until June 2010, Lucia was the sole owner of RJLC. Lucia Answer, pp. 1-2. Lucia was also sole owner of a network of financial companies associated with RJLC. Id., p. 1-2; Tr. 516. In addition to being

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[4] Lucia attended Palomar Junior College for a year and a half, beginning in 1967, Western Illinois University between 1968 and 1969, and San Diego State between 1969 and 1970. Tr. 1030. He received a bachelor's degree from United States International University in 1971. Tr. 1030. Lucia received a Series 7 license in 1983, a Series 24 license in 1997, a Certified Financial Planner designation in 1988, and a Series 63 license in 2002. Tr. 1032-35.

sole owner of RJLC, Lucia owned Lucia Financial, LLC (Lucia Financial), a registered broker-dealer for RJLC; owned RJL Enterprises, Inc., Lucia's media company; and partially owned LLK Insurance Services, LLC. Tr. 73, 516; Div. Ex. 2, p. 4. Lucia collected income from RJLC through Ray Sr. Sole Proprietor. Tr. 517.

2. RJLC

Lucia founded RJLC in 1994, and between 2006 and 2010, RJLC operated under the business name RJL Wealth Management. RJLC Answer, p. 1; Tr. 1026-27; Div. Ex. 2, p. 4, n.4. Between 2002 and 2011, RJLC was a registered investment adviser. Lucia Answer, p. 1; RJLC Answer, p. 1. RJLC had an investment committee, which performed diligence on proposed products and approved products that RJLC-affiliated advisors could sell.[5] Tr. 1301, 1569-70. Lucia and his son, Ray Lucia, Jr. (Lucia, Jr.) were members of the investment committee. Tr. 1076-77, 1301. Lucia, Jr. now operates RJL Wealth Management, LLC (RJLWM), a registered investment adviser and partial successor to RJLC. Tr. 1233-34; Lucia Answer, p. 1.

Between 2002 and 2007, RJLC had a network agreement with Securities America. Tr. 474, 1475, 1601. Lucia and Securities America jointly owned an investment adviser, RJL Financial Network, which

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[5] RJLC as an investment adviser did not directly sell securities. The securities were sold through the broker-dealer arm of RJLC's affiliated broker-dealers, Securities America, Inc. (Securities America), and later, First Allied Securities, Inc. (First Allied). Tr. 476, 502. The advisors would make the recommendations, and then execute the sales through the affiliate broker, with whom the registered representatives had independent contractor agreements. Tr. 476, 502.

operated as a joint business development effort to handle leads generated from Lucia's slideshow presentations. Tr. 446-47. Investment advisers for the joint venture, including Lucia, were registered representatives of both RJLC and Securities America. Tr. 475-76. Fees generated through the investment advisers were split between RJLC and Securities America, depending upon the source of the lead. Tr. 502. Lucia generated most, if not all, of the leads. Tr. 1075. Securities America reviewed marketing and advertising generated by Lucia and RJLC before public distribution, including radio and television spots and the slideshow presentations given by Lucia. Tr. 564-65, 683, 694; Resp. Ex. 20.

In 2007, RJLC and Securities America ended their network agreement. Tr. 474. Although there were apparently multiple reasons for the split between the companies, one such reason was an unfavorable audit of RJLC by Securities America in summer 2007. Tr. 454-60. At least one of the subjects of the audit was the BOM strategy; Theresa Ochs (Ochs), Securities America's relationship manager with RJLC, provided marketing materials to the auditors, including a booklet on the "bucket strategy," and answered auditors' questions about marketing materials. Tr. 456-58. In particular, Securities America had previously asked RJLC for the basis of its claimed REIT returns. Tr. 566. Ultimately, the chief compliance officer of Securities America told Ochs, who later became RJLC's chief compliance officer, that he would "make it very difficult" for Lucia to stay associated with Securities America. Tr. 460-61, 467-68. Following its split from Securities America, in 2007, RJLC entered into a similar networking agreement with First Allied, which lasted until 2011. Tr. 1475. Like Securities America,

First Allied reviewed advertisements, including television and radio spots, and marketing materials, including the slideshow presentation at issue, from a compliance perspective. Tr. 527-30; Div. Exs. 24-49; Resp. Exs. 25-29.

3. RJLC's Business Model

The Lucia family of companies has been very successful: it employed about eight people in 2000, and grew to employ 100 at the time of the hearing, with gross revenue of close to $20 million. Tr. 1220, 1347, 1693. In 2010, RJLWM employed forty-three investment adviser representatives and operated thirteen offices nationwide. Div. Ex. 2, p. 4. During the period between January 1, 2009, and January 31, 2010, RJLC and Lucia Financial generated a combined gross income of $14.1 million, of which RJLC registered representatives (including Lucia and Lucia, Jr.) generated advisory fees of approximately $1.7 million. Div. Ex. 4, p. 8; Tr. 1660. RJLC earned most of its investment adviser revenue by collecting fees for assets under management, but this constituted a paltry fraction of revenues in comparison with the commissions generated through sales of securities through affiliated brokers. Tr. 492, 1656; Div. Ex. 2, p. 7.[6] As of early 2010, RJLC had approximately 4,700 active accounts and $300 million in assets under management. Div. Ex. 2, p. 6; Tr. 491-92.

Sales of securities through RJLC's affiliated brokers were Respondents' main income generator. Between January 1, 2009, and January 31, 2010, Re-

[6] It also earned revenue for hourly charges, fixed-fee consulting arrangements, and management fees for wrap programs it co-sponsored. Tr. 492-93, 517.

spondents collected $12.4 million in gross commissions from sales of securities through First Allied, $8.7 million of which was paid to Lucia as commissions on the sale of non-traded REITs – undoubtedly the biggest revenue generator for Respondents during that period. Div. Ex. 2, p. 7; Div. Ex. 4, p. 8; Tr. 104, 1349. Through RJLC-affiliated representatives, RJLC clients invested more than $143 million in non-traded REITs during the same period. Div. Ex. 4, p. 8; Tr. 506. Of the $12.4 million in gross commissions from sales of securities, RJLC paid $2.7 million, or approximately 22%, to its registered representatives.[7] Div. Ex. 4, p. 8.

Lucia and Lucia, Jr. unconvincingly tried to downplay the importance of REITs to their bottom lines. Lucia reasoned that REITs generate a one-time fee, unlike other products, which continue to generate fees over time. Tr. 1348. Lucia was paid from his sole proprietorship, rather than from any one of his family of companies, and he paid much of the overhead of those companies, including salary, marketing, travel, and general office expenses. Tr. 1349, 1352, 1657. That is, Lucia's $8.7 million in gross commissions was not his actual take-home pay, and there have been years when his tax returns have shown a loss of close to $1 million. Tr. 1347, 1349. Lucia, Jr. emphasized that the revenues reported in the examination reports (Div. Exs. 2 and 4) were merely gross revenues, and did not account for expenses. Tr. 1661-62. He also testified that in 2011, which was a "transition year" in which revenues were down to about $16 million, the

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[7] RJLC used to pay its advisors based upon a percentage of sales commissions and fees, but in 2011, it moved to an all-salary employment model. Tr. 502, 1076-77, 1569.

Lucia family of companies lost $2 million. Tr. 1693-94.

Although I have no reason to doubt that Respondents have had good years and bad years, the Lucia family of companies are, overall, highly profitable, and Respondents have done very well for themselves, in part through their seminars. According to Lucia, Jr., August 2012 was a "record month," with $1.6 million in gross revenues. Tr. 1655. In 2011, the family of companies, despite the reported loss of $2 million, was still successful enough that Lucia, Jr. paid himself a $325,000 salary and took ownership withdrawals of "a couple hundred thousand" more, for a total of "about half a million dollars." Tr. 1694, 1701. Lucia, too, continues to collect a $300,000 salary from RJLWM in addition to fees for leads and a markup on advertisement sales on his show, $1.8 million of which came from RJLWM. Tr. 1025, 1697-99. Lucia admitted that there have been years when he has made $1 million. Tr. 1347.

More importantly, REITs generated "a high percentage of the revenue" for Respondents. Tr. 1347-48. Even assuming REITs generated the smallest profit margin of all the products sold, REITs were the clear moneymaker for RJLC (and RJLWM). According to Lucia, Jr., expenses in 2010 were "seven to eight million dollars a year plus rep comp and bonuses." Tr. 1661. As noted, representative compensation and bonuses were $2.7 million for January 2009 through January 2010. Div. Ex. 4, p. 8. Thus, total expenses for 2010 were at most approximately $10.7 million, compared to $12.4 million in gross commissions alone, leaving Lucia and RJLC with a substantial profit. Indeed, about 70% of gross commissions ($8.7 million) came from sales of non-traded REITs, which are by

themselves adequate to cover all overhead except compensation for registered representatives. Overall, therefore, non-traded REITs have been very important, even crucial, to Respondents' profitability, and Respondents possess and have possessed an overwhelming incentive to sell as many of them as possible.

4. Lucia Financial

Lucia Financial was a registered broker-dealer, wholly owned by Lucia. Tr. 73, 469. Lucia Financial acted as a "limited use" broker-dealer for RJLC, maintaining no client accounts. Tr. 471-72. Lucia Financial's sole purpose was to collect revenue from marketing reimbursements and marketing revenues paid to Lucia and RJLC. Tr. 472-74. Issuers of non-traded REITs paid marketing reimbursements to Lucia for hosting seminars on those products. Tr. 474. Marketing revenues were a portion of distribution fees earned through sales of non-traded REITs by advisors registered with First Allied (and previously Securities America) and RJLC. Tr. 474. Between January 1, 2009, and January 1, 2010, Lucia Financial collected $1,140,151 in marketing reimbursements and marketing revenue, 96% of which came from just four REIT issuers. Div. Ex. 4, p. 5; Div. Ex. 52.

5. Sale of RJLC and Lucia Financial

Citing his interest in devoting more time to his media career, in April 2010, Lucia sold RJLC's client accounts, as well as Lucia Financial's brokerage business, to his son, Lucia, Jr. Tr. 507-10, 1027. Following the sale, and beginning in June 2010, Lucia, Jr. wholly owned the registered investment adviser RJLWM, with the client accounts purchased from RJLC. Tr. 587, 1027. Additionally, Lucia, Jr. created

Lucia Securities, LLC (Lucia Securities), to take over the brokerage business from Lucia Financial and act as broker-dealer to RJLWM. Tr. 469, 587-89. Lucia maintains active involvement with RJLWM, including his investment adviser registration. Tr. 1024.

B. Buckets of Money

Lucia developed the BOM strategy in the mid-1990s, trademarking the term in 2000. Tr. 1037, 1046. After years of difficulty protecting the BOM trademark, in 2011 Lucia rebranded the strategy The Bucket Strategy®. Tr. 1047.

In its simplest terms, the BOM strategy advocates spending income and principal from safe assets prior to depleting riskier assets in a portfolio, giving the riskier assets sufficient time to grow, and lengthening the lifespan of investors' nest eggs.[8] Tr. 75, 800, 1055; Div. Ex. 1, p. 179.[9] Lucia based the strategy, in part,

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[8] The parties dispute the precise nature of the BOM strategy. The Division asserts that it "involves allocating a client's assets among three 'buckets,'" that is, it is an asset allocation strategy. Div. Br., p. 6. Respondents assert that it is a "retirement asset withdrawal strategy," and is neither a "model portfolio" nor an asset allocation strategy. Resp. Br., p. 30; Resp. Reply, p. 2. It is not necessary to resolve this issue, because the outcome would be the same however the BOM strategy is characterized. Accordingly, I assume without deciding that Respondents' characterization is the correct one.

[9] Div. Ex. 1, which is the same as Resp. Ex. 3, was produced by Respondents during a 2010 examination by the Commission's Office of Compliance Inspections and Examinations (OCIE). Tr. 68, 86. It is a version of the slideshow Lucia used during his seminars no earlier than March 1, 2009, and was apparently the most recent version of the slideshow provided during the 2010 examination of Respondents. Tr. 86, 582. Because Div. Ex. 1 is not paginated, the cited page numbers are the last three numbers of one of the Bates numbers on the exhibit, SEC-LA3937-

on information he learned after reading a 1998 article by John Bowen, Jr., in the journal Financial Planning, which advocated the idea of withdrawing income from less volatile assets before withdrawing income from more volatile assets. Tr. 1037, 1044-45.

Lucia presented BOM as a retirement strategy, touting its ability to ensure long-term, inflation-adjusted income.[10] Tr. 1055, 1073. A common marketing phrase used by Lucia was "aim to retire in comfort and safety." Tr. 347, 1082. Lucia offered, and RJLC advisors provided, free BOM plans for prospective investors, and the plans could include investment assets already held, proposed investments, or a combination of both. Tr. 729-30, 1068.

A typical "bucket" strategy consists of three buckets of assets, though it could involve more if necessary. Tr. 75, 610-15. The first bucket holds low-risk, liquid assets, such as certificates of deposit, structured notes, treasury notes, investment contracts, or other cash-equivalent investments. Tr. 727-28. Lucia encourages spending bucket one assets and the income generated from them before assets in either the second or the third bucket are used. Tr. 610-15. The second and third buckets contained progressively riskier assets; typically bonds and structured notes in the second, and stocks and REITs in the third. Tr. 728-29.

00XYZ, thus: "Div. Ex. 1, p. XYZ." For ease of reference, I cite only to the Division's exhibit. By contrast, Div. Ex. 21 is the version of the slideshow used during the 2003 Commission examination, discussed infra. Tr. 1484.

[10] Lucia and Richard Plum (Plum), an employee of RJLC who assisted in creating the backtests, testified that the strategy could be tailored to investors at any life stage. Tr. 908, 1056-57. However, retirees and near-retirees were the target audience. Tr. 1060.

RJLC did not typically manage first or second bucket assets. Tr. 727-28. RJLC managed at least a portion of third-bucket category assets for a majority of its customers. Tr. 729.

Lucia introduced BOM in his slideshow presentations, in his books, and on his website as a "time-tested" strategy based upon "empirical evidence" and "science, not art." Div. Exs. 10, 16; Tr. 624-25, 1050, 1111. Lucia also frequently referred to it as a "backtested" strategy. Div. Ex. 1, pp. 437, 467; Div. Ex. 50, p. 22; Div. Ex. 66, p. 47.

C. The BOM Seminars

The BOM seminars are the nucleus of Lucia's business. Lucia marketed his BOM strategy through free slideshow presentation seminars to prospective investors in cities across the country. Tr. 629-30, 1071; Div. Ex. 18. Lucia traveled to multiple cities every year, giving approximately forty BOM seminar presentations per year. Div. Ex. 18; Tr. 1070. Between March and May 2009, for example, Lucia listed on his website fifteen planned seminars throughout the country. Div. Ex. 27. The venues varied, but each typically held a few hundred people. Tr. 1061. Lucia estimates that he has given his BOM slideshow presentation to 50,000 people. Tr. 1061. The presentation included a series of PowerPoint slides, mainly introduced by Lucia, followed by, or preceded by, audience questions. Tr. 1066. Associates of Lucia, including Plum, would often attend the seminars and help field questions from audience members. Tr. 734, 736.

The purpose of these slideshows was to generate leads for RJLC, and now for RJLWM. Tr. 526, 1075. At the end of every presentation, Lucia handed out

contact cards, which attendees filled out and returned to Lucia and his associates. Tr. 279, 378, 436. RJLC's investment advisers followed up on those leads, offering a free BOM consultation. Tr. 1068, 1559. RJLC only made money if the seminar attendees met with an RJLC investment adviser, received the free BOM consultation, and then either purchased investment products through RJLC or opted to have an RJLC advisor manage a portion of the investor's portfolio. Tr. 1067-68.

D. The BOM Slideshow

At the heart of this proceeding is Lucia's BOM slideshow presentation that Lucia gave at his BOM seminars. Lucia has been giving a variation of the slideshow presentation since around 2000. Tr. 672. He has amended the slides over time, but the principles and the progression of the message have remained largely the same. Tr. 834-36; see also Div. Ex. 1 (2009 version of the slideshow); cf. Div. Ex. 21 (2003 version of the slideshow). Of the 126 slides in the slideshow, the first fifteen slides are focused upon investment concerns and goals, and another thirty-nine focus upon Lucia's confrontation of conventional investment wisdom and strategies. Div. Ex. 1. Lucia then progresses through a series of fictional investor portfolios to validate his strategy. Div. Ex. 1. After the fictional investors, Lucia introduces the BOM strategy and his backtests, twenty-seven and eighteen slides, respectively. Div. Ex. 1. Lucia is responsible for, and approves the content of, the slideshow. Tr. 572, 834, 1066-67.

1. The Fictional Investors

Suitably named fictional investors each start with $1 million in retirement savings, require $60,000 a

year in inflation-indexed income, and aspire to bequeath $1 million to their children. Div. Ex. 1, p. 420. The first three fictional investors, comprising twenty-one slides, are subjected to what Lucia asserts are the pitfalls of conventional investment strategies.

a. The "Conservative Campbells"

The risk averse Conservative Campbells invest only in low-risk instruments, including certificates of deposit, individual bonds, and Ginny Maes (securities issued by the National Government Mortgage Association). Id., p. 421. The Campbells' investments are considered "safe & guaranteed." Id. The Campbells' income withdrawals are not indexed for inflation, so even though they are able to withdraw $60,000 a year, over the course of decades, their purchasing power diminishes. Id., p. 422. Assuming the Campbells passed away after thirty years, their $1 million principal investments would still be worth $1 million, but assuming inflation, their principal sees its purchasing power diminish by more than half. Id., p. 423.

b. The "High Rolling Hendersons"

The risk tolerant High Rolling Hendersons invest 100% of their retirement savings in the stock market. Id., p. 427. If the Hendersons enjoyed a flat 10% return from the stock market every year, their portfolio would be worth $4,203,320 in thirty years. Id., p. 427. That total allows for an inflation-indexed withdrawal of $60,000 a year. Id., p. 427. Lucia criticizes such a strategy, however, because, as the slideshow presents, if the Hendersons had retired in 1973, right before the nadir of that period's "Grizzly Bear Market" (Grizzly Bear Market), they would have gone bankrupt within seventeen years. Id., p. 432.

c. The "Balanced Buttafuccos"

The Balanced Buttafuccos, who invested in a balanced portfolio of 40% bonds and 60% stock, are also subjected to a retirement date of January 1, 1973, leading into the Grizzly Bear Market. Id., p. 435. They enjoy income for only twenty-one years, until completely depleting their portfolio. Id., p. 436. The Buttafuccos' 60/40 stock and bond mix is what Lucia uses as a proxy for the industry standard balanced portfolio he frequently denigrates. Id., p. 437; Tr. 1272. The slideshow suggests that the Buttafuccos are the main comparator to Lucia's "bucketized" investors. Div. Ex. 1, p. 437. The Buttafuccos' results were described as "backtested." Id., p. 437.

d. The "Bold Bucketeers"

As a contrast to the three previous fictional investors, the slideshow next introduces the Bold Bucketeers, the first investors in the slideshow to structure a portfolio around BOM principles, and also the first fictional investors to invest in REITs. Id., pp. 439, 449. Having the same initial resources and goals as the three previous investors, the Bucketeers employ a three-bucket strategy, with the addition of REITs. Id., p. 465. The portfolio contains 40% stocks, 20% REITs, and 40% bonds–referred to in testimony as a "40-20-40" strategy. Id., p. 465; Tr. 780, 806-07. $200,000 is invested in REITs, which produce an assumed dividend rate of 7.75% per year, and $400,000 in stocks, which grow at an assumed 10% rate. Div. Ex. 1, p. 465. The REIT and stock market investments grow uninterrupted during a twelve-year period, ultimately leaving $1.4 million. Id., p. 465.

2. The Backtest Slides

a. The '73 Backtest

The slideshow reintroduces the Grizzly Bear Market following the three fictional investors and the Bucketeers. Id., p. 466. The following slide, titled "Back Tested Buckets," provides that the Bold Bucketeers' portfolio, with the same 40-20-40 investment assumptions, would be worth $1,544,789, twenty-one years after retiring on January 1, 1973 ('73 Backtest). Id., p. 467. The slide notes that the twenty-one year period compares to the same milestone at which the Balanced Buttafuccos had completely depleted their retirement portfolio. Id., p. 467. The dividend rate assumed for the REITs in the '73 Backtest is not disclosed in either the slideshow or the Webinar, although because the '73 Backtest contrasts what is essentially the Bold Bucketeers' portfolio against the same portfolio beginning on a particular date, it is likely to be 7.75% and seminar attendees would so assume. Div. Ex. 1, pp. 467-68; Div. Ex. 66, pp. 46-47. As with REIT returns, it is not entirely clear from the slideshow that the '73 Backtest assumed 3% inflation. Div. Ex. 1, p. 467. However, this fact does not appear to be in dispute. Resp. Br., p. 38.[11]

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[11] The "Back Tested Buckets" slide states that actual treasury rates of return were used for the bond bucket and S&P 500 returns were used for stocks. Id. Plum testified both that he did not know if that statement was true, and that it was false. Tr. 786, 874. Lucia testified that the actual S&P 500 Market rates for 1973 and 1974 were used, but that a flat 10% annual rate was used for each year thereafter. Tr. 1078-80. Lucia did not testify about the bond return used. Id. I find by a preponderance of the evidence that the statement was false, and that there is no evidence of the actual bond returns assumed. I note that Plum's

b. The '66 Backtest

Lucia next introduces backtests[12] for retirees who endure the market stagnation of the late 1960s.[13] Lucia introduced this section of his slideshow in 2005 or 2006. Tr. 1134-35. The first example, involving a 60/40 split of stocks and bonds (i.e., the Balanced Buttafuccos, although that name is not displayed in this portion of the slideshow), require $50,000 a year in inflation-indexed income. Div. Ex. 1, p. 472. The Buttafuccos' backtest, using actual S&P 500 returns for 1966-2003, actual United States Treasury Bill returns for 1966-2003, 3% inflation, and income from both stocks and bonds, are left with no income and a portfolio of just $30,000 by 2003.[14] Div. Ex. 1, p. 473.

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testimony on this point was very confusing. Plum initially testified that he did not know what bond returns were used, and that he believed that the same stock returns were used as for the Hendersons and the Buttafuccos. Tr. 786. However, the Hendersons' portfolio assumed both a 10% stock market return (in one scenario) and a return matching the S&P 500 (in the scenario beginning in January 1973), and the Buttafuccos' portfolio assumed a return matching the S&P 500, beginning in January 1973. Div. Ex. 1, pp. 427-28, 435.

[12] I use this term throughout the Findings of Fact only as a shorthand description of the contents of the slideshow. The meaning of the term, and its significance, is analyzed infra.

[13] The stock market between 1966 and 1982 produced stagnant returns. Tr. 1145-46, 1268. Lucia first began citing to the 1966 market stagnation period after consulting with his friend, actor and economic commentator Ben Stein. Div. Ex. 1, p. 470; Tr. 772. According to Lucia, the '66 Backtest was first conducted because of Stein's curiosity regarding BOM's results in a stagnant market. Tr. 1137-38.

[14] The Division's expert testified that the S&P 500 Market average is a commonly-used proxy for historical stock market returns. Tr. 944. Lucia and Plum testified that they used the S&P

Shifting back to the BOM strategy, the slideshow shows backtest results for the Buttafuccos, which again begins with $1 million in savings, requires $50,000 of inflation-indexed income per year, splits its investments 60% in stocks and 40% in bonds – no REITs – but with income from bonds first. Id., p. 474. Spending bond income first, according to the slide, allows the investors to collect $150,000 in income (presumably $50,000 indexed for inflation) in the year 2003, while maintaining a portfolio value of $1.2 million. Id., p. 475.

The next portfolio describes the BOM strategy, but with a 40-20-40 split with REITs (i.e., the Bold Bucketeers, although that name is not displayed in this portion of the slideshow). Id., pp. 476-77. The REITs are assumed to generate a 7% dividend rate. Id., p. 471. Unlike with the previous comparison of the four fictional investors, there was no explicit disclosure that the 7% REIT rate was hypothetical in the slides, nor was there an explanation for why the rate changed from 7.75%. Id., pp. 468-78.

With a pithy summary slide, Lucia declares, "[i]n 2003 . . . [a]fter adding REITs . . . [p]ortfolio value: $4.7 million[,] [a]nnual income: $150,000," more than tripling the portfolio balance. Div. Ex. 1, p. 477. Significantly, there are no fine-print disclaimers on any of the slides pertaining to the '66 Backtest, in contrast to virtually every other substantive slide, including those pertaining to the '73 Backtest. Div. Ex. 1, pp. 467-78.

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500 Market average as a proxy for historical stock market averages for the backtests. Tr. 794, 1284. Lucia and Plum also testified that United States Treasury Bill yields are reliable historical proxies for average bond rates, and that they used them as such in the backtests. Tr. 794, 1284.

E. Webinar

On February 16, 2009, Lucia broadcast a presentation (Webinar) over the internet. Div. Ex. 66, p. 1; Tr. 1244. Approximately the first two-thirds of the Webinar generally follows the same format and outline as the seminars, but does not use precisely the same slideshow.[15] For example, Lucia introduces a simplified version of the BOM strategy on pages 27-31 of the Webinar, earlier than in the seminar slideshow. Div. Ex. 1, pp. 410-12; Div. Ex. 66, pp. 27-31. The evidence is unclear as to why the Webinar deviates from the seminar slideshow. It may be that Lucia used a different slideshow in his internet presentations, or it may be that the slideshow changed between February 2009, when the Webinar aired, and 2010, when OCIE obtained a copy of the slideshow.

In any event, there are certain substantive differences between the Webinar and the 2010 slideshow. The Webinar sometimes calls non-traded REITs simply "real estate," and, if anything, the Webinar stresses the importance of REITs even more than does

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[15] For example, pages 364, 365, 367, 369, 370, 372, 373, 375, 378, 381, 384, 387, 390, 394, 406, 413, 416, 430, 438, 468, 469, 470, and 479 of the slideshow differ from the corresponding slides shown in the Webinar in certain non-substantive ways. Resp. Ex. 30; Div. Ex. 1. As another example, slides and hand drawings discussed on pages 13, 16, 17, 24-31, 34-38, 43, 47, and 56-58 of the Webinar do not appear in the slideshow, and pages 379, 389, 391, 415, 419, and 480-84 of the slideshow do not appear in the Webinar. Resp. Ex. 30; Div. Exs. 1, 66. Approximately the last third of the Webinar does not correspond to anything in the seminar slideshow. Div. Ex. 66, pp. 53-82. Oddly, the Webinar also states that Lucia only worked with salaried representatives. Div. Ex. 66, pp. 3, 51. In fact, the switch to purely salaried representatives occurred in 2011, well after the Webinar aired. Tr. 502, 1076-77, 1569.

the slideshow. Div. Ex. 66, pp. 34:12-14 ("we really focus a lot on nontradeable direct ownership in real estate"), 35:4-6 ("direct ownership in real estate . . . [is] not only a staple, it is critical"), 35:10-16 ("the Ibbotson data proves it, . . . a twenty percent addition to real estate investment trusts, be it tradeable or nontradeable, you end up with a higher rate of return at lower risk"), 44:19 ("real estate," in referring to the slide on page 449 of Div. Ex. 1, which states simply, "REIT"), 50:2-5 ("the real live [BOM] strategy . . . assume[s] we put . . . twenty percent in direct ownership in real estate," while displaying a slide showing "20% REITs"), 58:5-6, 19-20, 23-24 ("I'm going to put 300,000 dollars in my real estate bucket . . . the real estate can also help produce annuitized income . . . [and] will produce about 19,000 dollars per year"), and 69:17-18 ("the nontradeable real estate and all the safe buckets that we've talked about"). The first "Notes & Disclaimers (REITS)" slide in the slideshow does not appear in the Webinar at all, and although the second "Notes & Disclaimers (REITS)" slide appears in the Webinar, it does not disclose the fact that REITs have limited liquidity, in contrast to the corresponding slide in the slideshow. Div. Ex. 1, pp. 415, 447; Div. Ex. 66, pp. 35, 44. When discussing the BOM strategy in detail, Lucia states "in the sixties, you could have got about $15,000 per year income, dividends from that real estate investment." Div. Ex. 66, p. 44:22-25. Before discussing the effects of REITs in connection with the '66 Backtest, Lucia repeatedly uses the term "pretend" when introducing his assumptions. Div. Ex. 66, pp. 40, 48. However, when he discusses the effects of REITs, he does not use the term "pretend." Div. Ex. 66, p. 50:5. He then summarizes the result of the BOM strategy: "the real Buckets

portfolio, using real estate, 4.7 million dollars." Div. Ex. 66, p. 51:18-19.

F. Backtest Designs

Lucia testified that he did some of the work on the '73 and '66 Backtests used for the slideshow presentations, and that he "manually" calculated at least some of the results.[16] Tr. 1089, 1095. He also testified that he did not believe he had to produce any support for the backtests to the Commission during its examination, because he did not believe he had to maintain such records. Tr. 1094-95. Lucia and Plum testified that for the '73 Backtest, and for the fictional investors' results, Brian Johnson (Johnson) ran the calculations for the slides under Plum's supervision. Tr. 782-83, 839, 1088. Johnson was a junior employee who dated Lucia's daughter and, Lucia believed, had just graduated from United States International University, Lucia's alma mater, when he prepared the slides. Tr. 783, 1089. Plum did not check Johnson's calculations, but he reviewed his methodology and agreed it was correct. Tr. 784. Supporting documentation for the '73 Backtest calculations has never surfaced. Tr. 788.

In response to an investigative request for backtest slide support, Ochs produced two spreadsheets that she had received from Plum. Div. Exs. 12, 13; Tr. 87-89, 539-40.[17] The first spreadsheet laid out

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[16] Lucia also claimed to have backtested the BOM strategy to 1987, although he had no documentary evidence of this. Tr. 1094. There are no allegations of Lucia having presented the results of a 1987 backtest to the public.

[17] It is undisputed that the first spreadsheet, Div. Ex. 13, which Ochs apparently believed was support for the '73 Backtest, was produced during the examination. Tr. 87-88, 541-42. It is disputed whether the second spreadsheet, Div. Ex. 12, produced as

calculations for a fictional 40-20-40 portfolio beginning in 1973, but did not match any of the numbers from the slideshow. Div. Ex. 13; Tr. 788. The first spreadsheet does not support the '73 Backtest, nor was it intended to; instead, it is an "illustration starting in 1973 with the difference between a distribution from a pro rata portfolio of 60/40 stocks and bonds and spend safe money first over volatile money." Tr. 802.

The second spreadsheet, prepared by Plum at Lucia's direction, was intended as support for the '66 Backtest with REITs. Div. Ex. 12; Tr. 810. No support was provided for the '66 Backtest portfolio without REITs. Tr. 811.

In the second spreadsheet, REITs provided a flat 7% dividend return, were invested on day one, January 1, 1966, and were held for ten years, liquidating at the end of 1975. Div. Ex. 12; Tr. 218. The REIT principal remained constant at $200,000 through the ten year investment. Upon liquidation, the $200,000 was reinvested in the stock market, where the rest of the portfolio remained, growing at actual historical returns. Div. Ex. 12.

Both spreadsheets assumed a flat 3% annual inflation rate. Tr. 765; Div. Exs. 12, 13. The '73 Backtest presentation also stated that it utilized a flat 3% inflation rate. Div. Ex. 1, pp. 465, 467. Neither spreadsheet accounted for costs or fees associated with investments. Tr. 156, 1284; Div. Exs. 12, 13. In the second spreadsheet, after the first fourteen years

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support for the '66 Backtest, was produced during the examination or later. Tr. 112, 540-41, 810-11. As explained infra, neither spreadsheet actually supports the slideshow's claims. Accordingly, the probative value of the date of production of the spreadsheets is minimal, and I find that both were produced in the course of the 2010 examination.

the first two buckets, containing REITS and bond equivalents, were depleted. Div. Ex. 12. The balance remained allocated to a bucket of stocks, that is, the third bucket, from which income was withdrawn for the remainder of the backtests. Id.

G. REITs

In its simplest form, a REIT is a company that procures capital from investors by selling equity shares, uses the capital to purchase income-producing real estate assets, collects income, such as rent, from the assets, and then distributes the earnings back to investors. Div. Ex. 70, p. 10. REITs first became available to the investing public in the 1970s, but only became widely available in the 1990s. Tr. 774.

As applicable here, there are two general categories of REITS, traded and non-traded. Div. Ex. 70, p. 10; Tr. 1622. Traded REITs are traded on exchanges, are priced regularly, and are highly liquid. Tr. 166, 218, 1622. Non-traded REITs are inherently illiquid securities due to the lack of public market. Tr. 728, 1380. They are considered long-term investments, and Lucia and RJLC encouraged investors to consider them as such. Tr. 1297, 1621-23. Lucia and RJLC usually told clients to hold REITs between ten and fifteen years. Div. Ex. 1, p. 447; Tr. 1623. Non-traded REITs are designed to liquidate, merge, or be offered publicly at the end of their expected life cycles. Tr. 1370, 1392, 1623. Cycles are often between five and eight years. Tr. 1369, 1623.[18] Some non-traded REIT

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[18] Lucia, Jr. testified that the cycles typically lasted between seven and eight years, while Respondents' expert, Gannon, testified that the average cycles lasted between five and seven years. Tr. 1623, 1369-70.

issuers offer redemptions at certain predetermined intervals, offering investors cash to liquidate their shares. Tr. 1298-99. Redemptions, however, usually offer less than the original principal investment. Tr. 1299.[19] According to Lucia, Jr., non-traded REIT liquidity events do not have an established history, because "they haven't been around for more than a decade and a half or so." Tr. 1623.

As noted, non-traded REITs were the lifeblood of Lucia and RJLC's business, generating a substantial portion of revenues for them. Div. Ex. 4; Tr. 104, 1347. Additionally, non-traded REIT issuers offered the vast majority of marketing reimbursements to Lucia for hosting seminars and selling their products. Div. Exs. 4, pp. 5, 52; Tr. 104-05, 472, 483, 1077. Lucia himself was general partner or managing member of nine pooled-investment vehicles that invest in and manage real estate holdings. Div. Ex. 2, p. 9. Lucia and RJLC advocated, as an integral part of BOM, the use of real estate, specifically non-traded REITs, to prospective investors looking to "bucketize." Div. Ex. 1, pp. 471-78; Tr. 76, 1296-97; Div. Ex. 66, p. 35. Lucia cited reasons for advocating non-traded REITS as their relative lack of volatility and their ability to pay higher dividend rates than most traded REITS. Tr. 76, 1297, 1373.

H. Inflation

The Division alleges that Lucia's use of a flat 3% inflation rate for the backtest slides was materially misleading because the historical rates, which the Division alleges should have been used in backtests,

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[19] Lucia testified that many non-traded REITs have one-year redemption windows for repurchase of shares at about 90% of the original capital investment. Tr. 1299.

were significantly higher and would have negatively impacted the returns Respondents presented. Bryan Bennett (Bennett), an attorney adviser and former examiner in the Commission's Los Angeles regional office, testified that the Office of Compliance Inspections and Examinations (OCIE) recalculated what it believed was the '66 Backtest using inflation rates from the Consumer Price Index (CPI) maintained by the Bureau of Labor Statistics (BLS) and determined that the portfolio would have run out of money by 1986. Tr. 56-57, 81, 110-11. OCIE also calculated a 4.8% average inflation rate for the years 1966-2003 using CPI. Tr. 111. Bennett stated that BLS-gathered inflation rates are available online. Tr. 93.

Plum testified that Lucia made the decision to utilize a 3% flat rate for inflation in his backtests and that he had no problem with it. Tr. 776. Plum testified that he was aware that historical inflation rates were available, and he agreed that Bennett's calculation of a 4.8% average inflation rate for 1966 to 2003 was correct based upon BLS data, but stated that he did not believe the 4.8% rate accurately reflected inflation for retirees. Tr. 776-77. In his experience, Plum testified, retirees tend to spend less and have an inflation rate lower than CPI, thus, he believed 3% is a more accurate rate for retirees. Tr. 776-77, 867. Plum ran the '66 Backtest using the 4.8% average rate following institution of this proceeding, and agreed that the assumed portfolio would have run out of money earlier than 2003. Tr. 800, 815-16. Plum testified both that he did not know at the time of the '66 Backtest creation that historical inflation rates exceeded 3%, and that he knew "at times" that in the late 1970s and early 1980s, inflation had been double digits. Tr. 794-96. He testified that increasing inflation in the backtests would cause the backtests to run

out of money earlier, but qualified this by stating that BOM portfolios would still fare better than non-BOM portfolios. Tr. 800, 816. Although Plum testified he "ran" the '66 Backtest using inflation of 4.8%, no documentary evidence of such a test has surfaced. Tr. 800.

Lucia frequently stated that the BOM strategy would "provide inflation adjusted income for life" as a way of promoting use of the strategy. Tr. 1082-83. He assumed 3% inflation because it is a "generally accepted and reasonable" amount for forward-looking projections, which was what he says he was actually offering in his backtests. Tr. 1144-45, 1149. According to Lucia, he created the '66 Backtest in response to a question from Ben Stein, and Lucia presented it as a "forward-looking hypothetical" projecting a 3% rate. Tr. 1137-38. Lucia testified that the inflation rate in 1966 was 2.9% and that a 3% rate looking forward from that point was a reasonable projection. Tr. 1326. Lucia also stated that 3% was reasonable because the 100-year average of CPI is 3%. Tr. 1289. Lucia agreed that historical inflation data was publicly available, and he testified that he knew, intuitively, that historical inflation rates were higher than 3%. Tr. 1149, 1191. He testified that he understood that inflation rates were as high as double digits in the late 1970s and early 1980s. Tr. 1136.

Lucia testified that retirees spend less money than non-retirees and that inflation rates and cost of living increases for them are different than for non-retiree consumer spending. Tr. 1174-75. Lucia's position was based upon studies that he has researched and anecdotal experience with his 87-year old father. 1175-76. He cited to studies by various academics and

practitioners who concluded that inflation rates impact seniors differently than ordinary investors. Tr. 1289-90. Lucia did not dispute that using a higher inflation rate in the backtests would cause the assumed portfolios to run out of money sooner. Tr. 1150, 1203. Lucia added that the rest of the financial industry, including large investment houses like American Funds, used fixed assumed interest rates. Tr. 1147; Resp. Ex. 46.

The slideshow presented a 3% inflation rate for the Bucketeers' portfolio as "assumed" on only one slide; there is no similar disclosure elsewhere among the slides. Div. Ex. 1, pp. 422, 432, 465, 471-72, 474, 476. Lucia testified that he cautions seminar attendees that the 3% inflation rate is "assumed," or "pretend," and that actual historical rates were higher. Tr. 1190. Lucia stated in the Webinar, when staging the '66 Backtest with a 3% inflation rate, as evidence of his disclosures: "And let's pretend that from that point forward, inflation was 3 percent. We knew it was more. But we wouldn't have known that at the time." Tr. 1340; Resp. Ex. 30; Div. Ex. 66, pp. 48-49. Bennett agreed that the use of a 3% inflation rate was disclosed as an assumed rate on the slide for the non-backtested Bucketeers' portfolio. Tr. 135.

Lucia maintained during testimony that inflation rate projections often depend upon individual investor needs, which are discussed with potential clients when meeting with RJLC advisers and designing their individual BOM plans. Tr. 1143. This point was also made by Plum and Janean Stripe (Stripe), an RJLC adviser, in their testimony. Tr. 798, 1562.

I. Fees

OCIE discovered during its examination that the backtests did not include deductions for fees, even though RJLC told OCIE it charged advisory fees on products it managed, including stocks that would typically be included in a growth bucket. Tr. 154-55; Div. Exs. 12, 13. According to Bennett, Lucia's failure to include fee deductions in the backtests rendered them misleading. Tr. 154-55.

Lucia testified that he excluded fees from the backtests because he was using proxies for investments in his presentations, including the S&P 500 Index, which is not a purchasable product, as a proxy for the stock market, and T-Bills, which RJLC did not sell, as a proxy for the bond market. Tr. 1284; Div. Ex. 1, p. 416. According to Lucia, by excluding fees in a proxy-based portfolio, he was following financial planning industry practice, citing to an American Funds brochure as an example. Tr. 1270-71, 1284; Resp. Ex. 46. Bennett acknowledged on cross-examination that fees were also not deducted from the non-BOM hypothetical investor portfolios. Tr. 156.

Lucia testified that fees vary for individual investors and that for certain investors, like Richard DeSipio (DeSipio), an investor witness, there were no advisory fees associated with their portfolios because they were self-managed. Tr. 1285. Lucia testified that he made very clear to attendees at his presentations that fees were an important consideration and that potential investors should be sure to discuss them with an adviser. Tr. 1283. He testified that he stated at his presentations that even small differences in fees can make a big difference in return. Tr. 1199. His emphasis, however, was to inform attendees about the importance of BOM ahead of taxes and fee

sensitivity; he said, listing in order of importance, "Strategy first, taxation, fee sensitivity." Tr. 1283.

Stripe testified that there is no standard advisory fee charged to each client. Tr. 1564. If a portion of a plan is actively managed, there may be advisory fees associated with it. Tr. 1546. Stripe testified that the number of clients she has that pay advisory fees is low, somewhere around 25% in 2009 and 2010, which was consistent with the number of clients paying fees around the time of her testimony. Tr. 1546. Lucia, Jr. testified that advisers offered a broad spectrum of products, some commission-based and some fee-based. Tr. 1604. For example, RJLC recommends commission- and fee-based REITs. Tr. 1653. Lucia, Jr. testified that approximately 20% of the revenue for RJLC-affiliated companies comes from fees and the rest from trailing commissions on annuities and mutual funds, and first-year commissions from products that include mutual funds, REITs, and fixed annuities. Tr. 1656.

Potential clients who meet with RJLC advisers are provided with fee disclosures. Tr. 1285. Stripe, herself an RJLC adviser, confirmed that advisers discuss fees when potential clients meet with an adviser. Tr. 1564. Bennett agreed that RJLC disclosed fees to clients when they came in for a BOM consultation. Tr. 157.

J. Rebucketization

Bennett testified that Respondents failed to either follow the BOM strategy in the '66 Backtest or disclose that they did not, which made it misleading. Tr. 94, 96. He explained that, pursuant to the BOM strategy, after depleting the first and second buckets, an inves-

tor would withdraw portions of the third bucket to replenish the first and second buckets. Tr. 94, 96. In the '66 Backtest, however, Respondents depleted the first two buckets without ever replenishing them; instead, the entire portfolio was left in the stock market. Tr. 94, 96.

Plum testified that rebucketizing can be an important component of the BOM strategy, and that it should be done for most BOM implementers. Tr. 856. He testified that it was not required, though. Tr. 883. He agreed that in the '66 Backtest, there was no rebucketization following the depletion of the REIT portfolio, and that for the period between 1981 and 2003, 100% of the investments were in the stock market. Tr. 858. Plum testified that they deliberately did not rebucketize the '66 Backtest because they did not want to confuse people. Tr. 859. He elaborated that the point of the illustration was to show that spending safe money first, rather than using a pro rata distribution, was a superior strategy, and that was the only variable changed from the non-BOM strategy. Tr. 859-60. Plum testified further that there is no standard BOM formula and the decision to rebucketize is made on an individual basis. Tr. 883.

Lucia testified that he made a conscious decision not to rebucketize[20] the '66 Backtest because it would be misleading to do so. Tr. 1131, 1322. He explained that he was comparing BOM with no rebucketizing to a non-BOM strategy with no rebucketizing, and so rebucketizing the '66 Backtest would be a disingenuous comparison. Tr. 1130-31. Lucia acknowledged that he knew that during the periods the backtest portfolio

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[20] Lucia sometimes used the term "rebalance" instead of "rebucketize." E.g., Tr. 1130-31; Div. Ex. 66, p. 80.

was invested entirely in stocks, the stock market produced above average returns. Tr. 1145.

Lucia acknowledged that he did not provide "specific" disclosures of the investment allocations in the '66 Backtest following the depletion of the bond and REIT buckets. Div. Ex. 1, pp. 470-478; Tr. 1131. He testified that he makes it apparent in his presentations that the backtests are not rebucketized and provides context that would make the audience aware that the portfolio ends up invested completely in stocks, but explains that "in real life . . . it doesn't work that way." Tr. 1131, 1188-89. Lucia testified that though he did not include a slide indicating that the backtested portfolio ended up invested entirely in the stock market, he regularly engaged in an "oral conversation" with the audience and hand-drew illustrations explaining that rebalancing is not always necessary. Tr. 1186-87. He testified that he explained that academic research showed that stock investments have a 25-year time horizon, and investors can live off the dividends or income stream from the equity. Tr. 1186-87. He testified that academic research suggests that investors do not need to rebalance portfolios, and that he does not advocate it. Tr. 1132.

Plum and Lucia both acknowledged that the BOM strategy advocates against investing entirely in the stock market. Tr. 729-30, 1132, 1188. Ochs testified that Lucia has never advocated being invested 100% in the stock market, and that part of the BOM strategy involved replenishing the safe buckets when they are depleted. Tr. 536, 614.

Lucia testified that rebucketizing would be discussed on an individual basis by RJLC advisers with potential investors. Tr. 1130, 43. Lucia, Jr. and Stripe agreed. Tr. 1568, 1665. Lucia stated that he

always counsels attendees to meet with an adviser if they are interested in pursuing a BOM strategy, and to consider different scenarios before choosing a specific strategy. Tr. 1143, 1151, 1341.

K. Commission Examinations

In August 2003, compliance examiners from the Commission's Division of Investment Management's compliance office, a precursor office to OCIE, conducted an inspection of RJLC. Tr. 1478-79. That inspection uncovered several deficiencies, including inadequate disclosures of certain conflicts of interest and misleading statements about RJLC's business in its marketing materials. Div. Ex. 2, p. 7. These findings were reported to RJLC in a deficiency letter issued to the company on December 12, 2003. Resp. Ex. 13; Tr. 1492. One such deficiency pertained to a financial plan (not a slideshow) prepared for a client, in which RJLC made unsubstantiated and "highly unlikely" claims regarding REIT returns. Resp. Ex. 13, p. 6. The financial plan specifically mentioned that "income from the [REIT] could be used to supplement your Bucket #1 income." Id., p. 6 (emphasis omitted). RJLC told the 2003 examiners that it would correct the deficiencies. Resp. Ex. 14.

In March 2010, OCIE conducted an examination of RJLC and Lucia Financial, and OCIE found that RJLC had committed significant violations of the Advisers Act. Div. Exs. 2, 4. The examination was the impetus for the present enforcement action, and was triggered by a tip from the Division. Tr. 183, 185. OCIE issued a deficiency letter to RJLC on December 17, 2010, which outlined the deficiencies that form the basis of the present enforcement action. Div. Ex. 3; Tr. 70. Two of the noted deficiencies involved REITs, specifically that RJLC's marketing materials neither

(1) disclosed that non-traded REITs were not available during significant portions of the backtest period, nor (2) disclosed the illiquidity of non-traded REITs. Div. Ex. 2, p. 14; Div. Ex. 3, pp. 6-7. OCIE also found that RJLC had corrected some but not all deficiencies identified in the December 12, 2003, deficiency letter. Div. Ex. 2, p. 7.

As part of the examination, Bennett drafted an examination report. Resp. Ex. 50; Tr. 182. The report's cover letter, or "buckslip," was initially signed by three OCIE staff members on November 4, 2010. Resp. Ex. 50, p. 1; Tr. 29. The fourth and most senior staff member, Martin J. Murphy (Murphy), Associate Regional Director of the Los Angeles Regional Office, signed the buckslip on November 8, 2010. Resp. Ex. 50, p. 1; Tr. 181. After reviewing the report, Murphy had the matter referred to the Division because of the "seriousness of the advertising deficiencies." Tr. 184. The buckslip indicated no referral had been made to the Division; it is unclear why Murphy signed it first, and then initiated a referral. Resp. Ex. 50, p. 1. At some point, the examination staff met with the Division, and it was decided to amend the examination report by adding allegations of violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act, and rules thereunder, and by noting on the buckslip that a Division referral had been made. Tr. 200; Resp. Ex. 51. No later than November 22, 2010, the Division decided to open an investigation. Resp. Ex. 53, p. 2. A formal order of investigation (FOI) was approved on December 2, 2010, and the final version of the examination report was signed on December 16, 2010. Resp. Exs. 12, 51. Respondents first learned of the existence of the FOI in May 2011. Resp. Ex. 12. No Division staff asked Bennett to obtain information for the Division through the examination process. Tr. 214.

L. Expert Testimony

a. REITs

Dr. Steven Grenadier (Grenadier) testified as an expert witness for the Division on all the various issues that it asserts made Respondents' slideshow presentations misleading. Grenadier's expert report concluded that Lucia's assumed REIT dividend rates for the backtests were misleading, creating inaccurate returns for the fictional investors. Div. Ex. 70, pp. 10-11. Grenadier based his findings on indices published by the National Association of Real Estate Investment Trusts (NAREIT), specifically the FTSE NAREIT All REIT index.[21] Div. Ex. 70, p. 10 n.24; Tr. 944. NAREIT indices are well-known proxies for REIT returns. Div. Ex. 70, p. 11; Tr. 944. Grenadier found that there were very few publicly traded REITs available in 1966, at the start of the 1966 backtest. Div. Ex. 70, pp. 11-12. He found that public non-traded REITs were relatively more available as of 1966, but were illiquid. Div. Ex. 70, p. 12. Additionally, NAREIT, the most famous REIT index, began reporting in 1972, six years after the '66 Backtest began using its assumed 7% return. Div. Ex. 70, p. 11; Tr. 944. He also found that using the NAREIT All REIT index provided significantly lower returns for the REIT principal and total portfolio for the '73 and '66

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[21] Grenadier testified that he used the All REIT index instead of specifying the equity REIT index because the All REIT index represents a general proxy average for the industry, much like why Lucia used the S&P 500 Market as a proxy for the stock market in general. Furthermore, Grenadier considered the All REIT index over the equity REIT index because the proportion of mortgage REITS might have been higher in the 1970s, which was when the bulk of the '66 Backtest REIT investment was supposed to have occurred. Tr. 962.

Backtests. Div. Ex. 70, p. 11 & n.24; Tr. 961-62. Grenadier also took issue with the assumption in the backtest that REITs could grow at a risk-free, flat rate, and then be easily liquidated. Div. Ex. 70, p. 12; Tr. 943.

Using actual historical data, Grenadier showed, lowered the REIT principal investment substantially. Div. Ex. 70, Ex. 5a. When the REIT investment ended in 1975 by liquidation, the backtest showed the REIT, with historical rates, at $85,646, not $200,000. Id.

Respondents called Kevin Gannon (Gannon) as an expert witness to testify on the issue of REITs as they were used in the '73 Backtest and '66 Backtest. Gannon's report concluded that the assumed REIT rates were reasonable. Resp. Ex. 34, p. 7; Tr. 1366. His report found that between 1972 and 2003, the internal rate of return was 12.9%, which was "so high that a 7% [rate] is clearly reasonable." Resp. Ex. 34, p. 4; Tr. 1390.

Gannon took issue with Grenadier's use of the NAREIT All REIT index. Tr. 1374-76. Gannon testified that the Equity REIT index, which includes REITs invested only in real estate equity, was the more reasonable index to consider. Tr. 1374. As part of his rationale, he found that the more widely used REIT index today is the Morgan Stanley REIT index, which is focused upon equity REITS. Tr. 1374, 1376. Gannon also concluded that equity REITs were the subject of the backtests because at least two slides in Lucia's slideshow cited statistics from the NAREIT Equity REIT index. Tr. 1374-75; Div. Ex. 1, p. 416.

Gannon's report recognized that REIT historical data was not available for the six-year period prior to 1972. Resp. Ex. 34, p. 6; Tr. 1366. He also admitted

on cross-examination that REITs were generally not available between 1966 and 1971 and that non-traded REITs are illiquid. Tr. 1378-80. To compensate for the unavailability of REITs from 1966 through 1971, Gannon created a model security based upon structured real estate investments during that period. Tr. 1380. The model was based upon inputs backed by thirteen assumptions. Tr. 1367, 1381. The model security produced a 7.1% internal rate of return. Resp. Ex. 34, p. 7; Tr. 1367. The evidence gathered for the model consisted of a single article, The Long Cycle in Real Estate, by Ronald W. Kaiser (Kaiser Article), which summarized total real estate returns between 1919 and 1995. Tr. 1378-79; Resp. Ex. 34, p. 7 & Ex. D (14 Journal of Real Estate Research, no. 3, 1997). The Kaiser Article drew its empirical data for the 1966-1971 period in part from a study published in 1976, How Real Estate Stacks Up to the S&P 500, by D. Kelleher in (Kelleher Study).[22] Resp. Ex. 34, p. 7 & Ex. D.

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[22] I find Gannon's testimony and expert report to be highly probative regarding the '66 Backtest. In addition to his significant concessions regarding REIT availability between 1966 and 1971 and REIT liquidity, both of which are specifically cited as deficiencies in the 2010 deficiency letter, a close examination of Gannon's supporting data is revealing. Div. Ex. 3, pp. 6-7. Gannon's report includes as Exhibit C a printout of the yearly NAREIT Equity REIT index averages. Resp. Ex. 34, Ex. C. Assuming without deciding that the NAREIT Equity REIT index was the appropriate data source, the price of an average REIT investment would have dropped substantially between 1972 and 1975, based on an index decline from 100 to 85.6. Id. Additionally, Gannon's starting assumption, that the "average total return" from real estate between 1966 and 1971 was 10.6%, was based on the Kelleher Study. Resp. Ex. 34, p. 7. The Kelleher Study, like the other studies cited in the Kaiser Article, and like Gannon himself, calculated "total return" or internal rate of return (IRR),

John S. Hekman, Ph.D (Hekman), the other expert witness for Respondents, could not recreate the '73 Backtest to achieve the same final portfolio figures presented in Lucia's slideshow. Tr. 1535-37. He testified that the term "backtest" was used on one slide in the slideshow, that the various examples in the slideshow were not, in his opinion, backtests, that his opinion was based on what an average investor would understand the term "backtest" to mean, and that the average investor would understand the term, in this context, to mean "using historical data to test a particular investment strategy."[23] Tr. 1402, 1423-26.

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i.e., the combination of dividends and price appreciation. Resp. Ex. 34, p. 3 & Ex. D, p. 237 n.4. Gannon ultimately estimates that the IRR between 1966 and 1971 for REITs would have been 7.1%. Id., p. 7. But Lucia did not tout the IRR for REITs, he touted the dividend rate. Div. Ex. 1, pp. 460, 465, 471. In other words, Gannon and Lucia were discussing two different returns: Gannon analyzed dividends plus price appreciation, and Lucia discussed just dividends. Gannon's evidence, therefore, does not really support Lucia's position; to the contrary, it undermines it. Specifically with respect to the '66 Backtest, Lucia assumed a 7% return, which represents the "annual," i.e. dividend, rate, and no price appreciation, according to the second spreadsheet. Div. Exs. 12, 1, p. 471. But Gannon concludes that, at least for 1966-71, the combination of yearly dividend and price appreciation is 7.1%. Resp. Ex. 34, p. 7. For the '66 Backtest to be consistent with Gannon's evidence, price appreciation would have to be approximately 0.1% between 1966 and 1971. This is, of course, highly unlikely, and it is much more likely that the price appreciation would have been higher, with a concomitant yearly dividend of less than 7%.

[23]. Hekman's testimony on these last two points is disjointed and confusing because he was repeatedly impeached on the subject, but I believe this to be a fair interpretation of what he said.

b. Inflation

Grenadier testified that a proper backtest, especially for a strategy that is supposedly able to keep up with inflation, should use historical inflation rates. Tr. 953, 978. Grenadier's expert report states that the results of the backtests were misleading because they did not use historical inflation rates; had they done so, both portfolios would have been completely drained by1986 for the '66 Backtest and 1989 for the '73 Backtest. Div. Ex. 70, pp. 6-8, Exs. 2a-3c. Grenadier determined the portfolios' collapse dates by using the same data used in Division Exhibits 12 and 13, but replacing the 3% inflation rate with actual historical inflation rates reported by BLS. Id., pp. 7-8, Ex. 2a-3c. Grenadier testified that the periods of the backtests included years of historically high inflation, including during the 1970s OPEC oil embargo. Tr. 941. Many of the high inflation years, according to Grenadier, occurred early in the backtest periods, which would have caused faster depletion of the portfolios because there would be smaller remaining investments to recoup losses. Tr. 941. Using an average inflation rate was, according to Grenadier, misleading, just as was use of an ahistorical rate. Div. Ex. 70, pp. 8-9. Grenadier admitted that the American Funds brochure Lucia discussed used an average 4% inflation rate in what the brochure called backtests, which he stated might be materially misleading. Tr. 974-76; Div. Ex. 46. Grenadier agreed that retirees over the age of 65 tend to spend less than their counterparts, but he testified that has nothing to do with inflation. Tr. 970-71. Grenadier also agreed that the rate of inflation between 1926 and 2003 averaged roughly 3%. Tr. 964-65.

Both Grenadier and Hekman testified that BLS publishes CPI for different categories of consumers. Tr. 937-38, 1527. CPI-U, for urban consumers, is the most commonly used measure of inflation. Tr. 937-38; Div. Ex. 70, pp. 7-8. CPI-E, which measures inflation for the elderly, is available for years after 1982. Div. Ex. 70, pp. 7-8. Grenadier tested the data in Div. Exs. 12 and 13 using CPI-U for the entire periods, which is reflected in Exhibits 2a, 2b, and 2c to his expert report, and he also tested the data using CPI-E, for periods after 1982, and CPI-U between 1966 and 1982, before CPI-E data became available, which is reflected in Exhibits 3a, 3b, and 3c to his expert report. Div. Ex. 70. In both sets of tests, the backtests ran out of money in 1986 and 1989 for '66 and '73, respectively. Id., pp. 7-8, Exs. 2a-3c. Grenadier testified that CPI-U and CPI-E differ year to year, but that CPI-E was higher than CPI-U during the relevant period. Tr. 940.

Hekman's expert report concluded that Respondents' use of a 3% inflation rate was reasonable. Resp. Ex. 35, pp. 1, 14; Tr. 1400-01. Hekman opined and testified that he considered Lucia's portfolio examples hypotheticals, not backtests, despite their being labeled as such, and that seminar attendees would understand as much. Tr. 1424, 1541-42; Resp. Ex. 35, pp. 3-4. He, thus, did not opine on the reasonableness of 3% as an inflation rate in a backtest. Tr. 1424, 1542; Resp. Ex. 35, pp. 3-4. Hekman opined that 3% is a commonly used hypothetical inflation rate, is used in many retirement and portfolio projections,[24] and is

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[24] Hekman cites to several large organizations that use a 3% inflation rate in their projections, including the U.S. Office of Personnel Management, TIAA-CREF, and CalPERS. Resp. Ex. 35, p. 5.

the historical average long-term rate for 1926 to the present. Resp. Ex. 35, pp. 4-5. As an added basis for his conclusion, Hekman opined that the inflation rate Lucia used did not affect the purpose of the investment hypothetical. Id., pp. 6-8. That is, the investment conclusion reasonable investors would draw from Lucia's hypothetical would have been the same whether or not Lucia used historical rates or the hypothetical 3% rate. Id., pp. 11-14.

Hekman opined that CPI is regarded as higher than true inflation, especially for seniors, citing a report from the Boskin Commission, created by the Senate Finance Committee in 1995 to study CPI (Boskin Report), and a paper by Professor Robert Gordon. Resp. Ex. 35, pp. 8-9; Tr. 1405. Hekman opined that a truer rate of inflation would incorporate a 1.2% reduction from CPI for the years between 1966 and 1996 and a 1% reduction beginning in 1997, as the Boskin Report suggests. Resp. Ex. 35, p. 9; Tr. 1405. After receiving Hekman's expert report, Grenadier ran the same tests using Hekman's proposed modified rate of inflation. Tr. 952, 967-68. Grenadier found that with the reduced inflation rates, the '66 backtest portfolio would have run out of money in 1993. Tr. 952. Hekman agreed that using his proposed reduced CPI rates would still cause the portfolio introduced as the '66 Backtest to run out of money in 1993. Resp. Ex. 35, Appx. 10; Tr. 1540.

Hekman further opined that seniors tend to spend less than average consumers and, thus, inflation would need to be corrected downward to reflect that fact. Resp. Ex. 35, pp. 13-14. Hekman determined that a 2% reduction each year from needed income would accurately reflect the true rate of inflation combined with seniors' reduced spending rates. Id., pp.

10, 13-14; Tr. 1539. Hekman testified that the 2% reduction was based upon studies by the Employee Benefits Research Institute (EBRI), which concluded that seniors tend to reduce their spending by about that much between the ages of 65 and 95. Tr. 1520. Inputting the reduced rate resulted in the '66 Backtest retaining $6.6 million in 2003. Resp. Ex. 35, pp. 13-14, Appx. 11.

c. Impact of Fees

Grenadier opined that the failure to include implementation costs and fees for the investments in the backtests produced significantly overstated and misleading results. Div. Ex. 70, pp. 2, 13-14. Grenadier opined that including implementation costs in a backtest is important because they may reduce or even eliminate the benefits of a strategy. Div. Ex. 70, p. 13. He wrote in his expert report that, at a minimum, funds that track the S&P 500, investments in T-Bills, and REIT investments would carry transaction and management costs. Id.; Tr. 945. It would be necessary, according to Grenadier, to incorporate actual or hypothetical costs into the backtests to provide a realistic result. Div. Ex. 70, pp. 13-14; Tr. 945. Accordingly, Grenadier incorporated example mutual fund fees, keeping all other data, including the 3% inflation rate that Lucia used, and found that both backtest results would be significantly reduced.[25] Div. Ex. 70, pp. 13-14; Tr. 945.

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[25] Grenadier noted in his expert report that there were generally no equity index funds that tracked the S&P 500 prior to 1977, so for between 1966 and 1976, he input average mutual fund fees for equity mutual funds, according to conservative estimates compiled by John C. Bogle in Bogle on Mutual Funds. Div. Ex. 70, p. 14. For after 1977, he used the rate collected by

Respondents did not offer any expert testimony on the issue of fees in the backtests.

d. Rebucketization

Grenadier's expert report states that a clear articulation and implementation of the strategy being tested is necessary to perform any backtest, as well as to verify the accuracy of any claimed backtest. Div. Ex. 70, p. 14. He found that Respondents' backtest illustrations did not present a clear asset allocation strategy, and the spreadsheets concentrate assets in a manner inconsistent with the BOM strategy as outlined in the rest of the presentation, making them improper backtests of the BOM strategy. Id., pp. 4, 14-15. Grenadier explained that the slideshow presentation discusses the importance of asset allocation, and that individual buckets are rebucketized periodically to maintain consistency in the strategy. Id., p. 15. According to Grenadier's expert report, the allocations presented in the slideshows for the '66 Backtest were not maintained over time, without explanation. Id. After the REIT and bond depletion, the '66 Backtest became entirely invested in the stock market. Id. Investment entirely in the stock market is inconsistent with discussions in the rest of the presentation urging asset allocation and diversification. Id., pp. 15-16. Grenadier included in his expert report graphs illustrating the benefit gained by Respondents by designing the backtest to allocate all investments into the stock market after depleting the first two buckets through withdrawals. Id., pp. Exs. 7a-7b. He testified that prior to the shift to the complete allocation into the stock market in the '66 Backtest, the market averaged 6% annual returns, whereas for the years after

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the Vanguard 500 Fund, which is one of the first equity index tracking funds and is considered one of the least expensive. Id.

1980, when the portfolio was entirely allocated to stocks, the market averaged 15% in annual returns. Tr. 948; Div. Ex. 70, Exs. 8a-8b. He concluded that failure to rebucketize the backtests, or failure to disclose that they were not, was misleading. Div. Ex. 70, pp. 14-17.

Respondents did not offer any expert testimony on the issue of rebucketizing.

M. Client Testimony

Two RJLC clients, DeSipio and Dennis Chisholm, testified at the hearing. Both were attendees at BOM presentations, DeSipio in Philadelphia, Pennsylvania, and Chisholm in Portland, Oregon. Tr. 247, 337. Chisholm also heard similar BOM discourse through Lucia's radio show, and read about the same, presumably in Lucia's books. Tr. 358-60. Both clients testified that the BOM presentations inspired them to meet with an RJLC advisor. Tr. 280-81, 370-71, 378-79. Both clients also invested in REITs because of what they learned at the presentations. Tr. 281, 283, 380.[26] A convincing aspect of the show, in particular, was the backtests.[27] Especially convincing to both clients was the effect of non-traded REITs. Tr. 266, 359-61, 368-69.

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[26] Q: Was it a large factor in your decision?

A [DeSipio]: Well, it was – it gave me – the whole purpose was – to me, I looked at it from the non-trade[d] REITs as another diversification which I was not aware of and did not have as far as financial asset allocation. Tr. 281.

[27] Chisholm testified, "If it was back-tested, I felt confident that somebody had done their homework and it proved somehow, some way, that this method was, indeed, a legitimate method of investing, of taking care of my retirement going forward." Tr. 362-63.

Both clients remembered Lucia presenting the backtests and using that term in conjunction with the '73 Backtest and '66 Backtest slides. Tr. 258, 359. Both clients understood the slides to suggest that Lucia used actual historical returns, or at least accurately reflected the approximate returns for the historical periods. Tr. 267-69, 371-72, 378. Both clients testified that they would have liked to have known that the backtests did not use historically accurate information. Tr. 288-91, 371-75. DeSipio did not recall being told that the inflation rate was assumed or hypothesized during the seminar, but recalled seeing a slide that said so. Tr. 295-96. He agreed that the slide summarizing the non-backtested Bucketeers' portfolio stated that it used an assumed rate. Tr. 295-96. Chisholm did not recall one way or the other whether Lucia said that the backtests used an assumed rate. Tr. 364. After being shown the same Bucketeers' slide as DeSipio, he agreed that it said it used an assumed 3% rate. Tr. 406. Both clients testified that they believed the 3% inflation rate used in the backtests was historically accurate or close thereto, and Chisholm testified he would have changed his opinion of the strategy if he had known the rate was not historically accurate and that historical rates would bankrupt the backtest portfolios. Tr. 260, 267, 364.

Both clients testified that they understood that for BOM to work, investors had to rebucketize. Tr. 250, 357. Chisholm testified that he was unaware that the backtests were not rebucketized, and he stated he would not have invested with RJLC had he known that fact. Tr. 374-75. Chisholm also testified that he did not remember Lucia disclosing that the backtests were not net of fees or the effect fees could have on the backtests. Tr. 374.

III. DISCUSSION AND ANALYSIS

A. Backtests

1. Definition

The parties dispute the definition of the term backtest. The Division asserts, through its expert, Grenadier, that, "[a] back-test of an investment strategy uses historical data to evaluate how that strategy would have actually performed had it been implemented in the past. Back-tests are generally conducted using actual, historical data – to the extent such data is available – especially for critical aspects of a particular investment strategy." Div. Ex. 70, p. 5. Grenadier bases his definition on "numerous textbooks and articles," discussing the importance of using actual, historical data. Id. Grenadier testified that he "very quickly" determined that the slideshow's presentation did not include proper backtests, according to the definition he offered. Tr. 960-61. Bennett, the OCIE examiner, testified that a backtest was a "method used to go backwards in time to see how a certain strategy would have performed using actual data points to calculate the performance." Tr. 114. Ochs had a similar understanding. Tr. 575. Bennett testified that what Lucia offered was not a proper backtest. Tr. 114.

Respondents' experts, Gannon and Hekman, both provided similar definitions of backtests – "Q: Is that because you would use actual data in a backtest? A [Gannon]: Yes;" "Q: [Y]ou agree that back-testing is generally understood as a process of evaluating a strategy, theory, or model by applying it to historical data? A [Hekman]: I understand – yes, I agree with that definition." Tr. 1387, 1421. Gannon testified that hypothetical rates of return should not be used in

backtests and Hekman testified that Lucia's analyses were not proper backtests. Tr. 1387, 1421.

Lucia disputes the backtest definitions given by the Division's expert, as well as by his own experts. Lucia testified that a backtest, "in the financial planning industry," was a "look back in history, but basing that on a forward-looking projection." Tr. 1093. Plum, too, claimed that he understood a backtest to mean a "hypothetical what if." Tr. 836. Lucia and Plum, the principal architects of the slideshow backtests, were the only two individuals who characterized the definition of backtests as something other than what the experts offered.

Lucia went on to state that this definition was based on what the financial planning industry "almost uniformly used." Tr. 1093. Despite Lucia's invocation of the "industry standard," none of the experts, including Respondents', corroborated that definition. Respondents also offered examples of backtests from several large investment houses, but those examples actually undermine Respondents' argument. Respondents point to Exhibit 46, a marketing pamphlet from American Funds, a large investment house, Exhibit 47, a marketing pamphlet from Fidelity Investments, and Exhibit 59, a marketing brochure from Financial Engines Income+, in support of what they assert is the industry usage of the term backtest. Tr. 1093; Resp. Br., p. 58. A review of Exhibit 46, however, reveals that actual "historical index returns" were used for the backtests, contradicting Respondents' assertion of what they proffer as the industry definition. Resp. Ex. 46. The example in Exhibit 47 used "historical monthly performance . . . represented by S&P 500, U.S. Intermediate –Term Government Bonds, and U.S. 30-day T-Bills." Resp. Ex. 47. Similarly, Exhibit

59, which does not specifically offer its models as backtests, uses only S&P 500 Market returns and Treasury Bond fund returns, both with factual, historical data. Resp. Ex. 59.

I also find that prospective investors would have understood the term in the same way as the experts. Dr. Hekman testified that the average investor would understand the term, in this context, to mean "using historical data to test a particular investment strategy." Tr. 1423-26. DeSipio understood the term to mean that actual performance data and actual inflation had been used. Tr. 267-69. Chisholm understood the term as a way of "prov[ing] somehow, some way, that this method was, indeed, a legitimate method of investing." Tr. 362-63.

I find the definition of "backtest" offered by all three experts the only consistent and intuitive one. Thus, a prospective investor at one of Lucia's seminars would have understood the term "backtest" to mean "using historical data to test a particular investment strategy."

2. Respondents' Use of Backtests

Lucia used the term backtest in his slideshow and narration, in his Webinar, in his training materials, and in his books. Div. Ex. 1, pp. 437, 467; Div. Ex. 50, p. 22; Div. Ex. 66, p. 47; Div. Ex. 68, p. 57. Lucia's employees, Ochs and Plum, and Lucia, Jr., testified that Lucia told audience members on numerous occasions at his seminars that he had "backtested" his strategy. Tr. 537, 880, 1686.

Notwithstanding Lucia's frequent invocation of the term backtest, the backtested slides used a jumble of actual historical returns and assumed returns. The slides for both backtests state that they used S&P

Market 500 averages and actual treasury rates of return. Div. Ex. 1, pp. 467, 471. Meanwhile, they used assumed dividend rates, including 7% for the '66 Backtest, probably a 7.75% dividend for the '73 Backtest, and a flat 3% inflation rate for both. Div. Ex. 1, pp. 467-78. It is quite clear that Lucia's backtest slides do not reflect properly conducted backtests.

Lucia, Lucia, Jr., and at least one senior employee of RJLC, after learning what the Division's definition of backtest was, tried to redefine what Respondents were providing with the backtest slides. Instead of a backtest, the slides represented: a "forward-looking hypothetical" (Lucia); "hypothetical forward-looking" scenarios (Plum); or "a simulation" (Lucia, Jr.). Tr. 1127, 840, 1627-29. Lucia also described what he was doing, at least for the '66 Backtest, as "pretending today is 1966." Tr. 1138. In the face of Lucia's persistent allusions to backtesting his strategy, I do not accept the inconsistent, after-the-fact descriptions of what Lucia and others testified Lucia was actually portraying, instead of a backtest.

3. Scope of the Backtests

The OIP alleges that "it was materially misleading for Respondents to claim that their alleged backtesting validated the BOM strategy," in connection with the 1966 and 1973 backtests. OIP, p. 7. In particular, the OIP alleges that "the BOM strategy," when backtested as presented in the slideshow, yields better outcomes than when backtested using actual historical data. Id., pp. 7-8. The OIP does not specifically allege that any claimed backtesting of the portfolios of the High Rolling Hendersons and the Balanced Buttafuccos, for comparative purposes, was

misleading. Div. Ex. 1, pp. 432 (discussing High Rolling Hendersons, assuming retirement on January 1, 1973), 437 (discussing Balanced Buttafuccos' results when "backtested to 1973-74" (footnote omitted)). The many slides devoted to the initial discussion of the Bold Bucketeers cover only 13 years, and it is not clear that either 1966 or 1973 is one of those years. Id., pp. 438-65. Indeed, the initial Bold Bucketeers discussion does not include any actual historical data, so it would not matter whether the discussion included 1966 or 1973; the outcome would be the same regardless of the period covered. Id., p. 465. It is only after the "'73/'74 Grizzly Bear" is introduced, and the assumptions become a mix of actual historical data and assumed data (for inflation and REIT returns), that the slideshow purports to compare the Bold Bucketeers with the Balanced Buttafuccos over a period including 1973. Id., pp. 466-68. Accordingly, although the OIP's citations to the "1973 backtest" could be construed as referring to purported backtesting both of the BOM strategy and of the portfolios of the High Rolling Hendersons and the Bold Bucketeers, it is more reasonable to construe it only as referring to purported backtesting of the BOM strategy starting in 1973 and 1966. Thus, although the entirety of the slideshow is relevant to this proceeding, I conclude that the focus of the OIP's allegations is on only thirteen pages of it. Div. Ex. 1, pp. 466-78.

B. The Central Importance of the Backtests

The backtest slides are the capstone of the slideshows, and the '66 Backtest is the pinnacle. Respondents imply that the backtests were discrete, standalone slides and meant little to the overall message. Resp. Br., p. 32. On that point, Respondents cite the fact that the word backtest was used only

twice in the entire slideshow. Resp. Br., p. 32. To the contrary, I find that the slideshow was a carefully orchestrated progression toward the backtests, which espoused the final proof that BOM, with REITs, is the best retirement strategy.

The first half of the slideshow is spent criticizing conventional investment wisdom and problems with following traditional portfolio models. It is only the second half of the presentation that begins the BOM strategy comparison. Lucia then uses a series of fictional investors who, following traditional investment advice, fail to obtain their retirement investment objectives. Div. Ex. 1, pp. 419-37. He makes certain assumptions for investment returns (actual returns for stocks and bonds and assumed returns for everything else) and inflation, runs the numbers, and presents the results. Id. He emphasizes that the High Rolling Hendersons and Balanced Buttafuccos suffer from the effects of the 1973 stock market, and ultimately characterizes his Balanced Buttafucco analysis as "backtested to 1973-74." Id., pp. 428, 435-37. He then analyzes the Bold Bucketeers using the same approach, but with a different asset allocation and withdrawal strategy than the previous fictional investors. Id., pp. 437-65. A reasonable prospective investor, viewing the slideshow's presentation of essentially the same methodology for the four different fictional investors, would understand that all four assumed portfolios had been backtested, just as the Balanced Buttafuccos' had.

The '73 Backtest slide, entitled "Back Tested Buckets," compares the Bold Bucketeers (who invest in REITs) to the Balanced Buttafuccos (who do not), over the period 1973 to 1994. Id., p. 467. The result is an investment principal in 1994 of $1,544,789 for

the Bold Bucketeers, compared to $0 for the Buttafuccos. Id., p. 467. The kicker comes, however, with the '66 Backtest. The '66 Backtest without REITs weathers thirty-eight years to provide an ending principal of $1.2 million. Id., p. 475. The next slides introduce the same investment portfolio, but add a 20% investment in REITs, and the ending principal of the portfolio more than triples to $4.7 million in the same period. Id., p. 478. To be sure, the slideshow does not explicitly display the term "backtest" in discussing the '66 Backtest. Id., pp. 468-78. However, it does use the term "Back Tested Buckets" in discussing the '73 Backtest, and in context the clear implication is that the 1966-2003 results were also backtested. Id., p. 467. For example, the slideshow asks, "what would have happened if you retired in 1966 . . .," and lists various "Notes and Assumptions," suggesting that the 1966-2003 results were analyzed in a way similar to the '73 Backtest. Div. Ex. 1, pp. 470-71. Any reasonable prospective investor would have interpreted these slides, too, as suggesting that the results had been backtested.

Respondents nonetheless argue that a reasonable investor would understand that the slideshows did not present backtests. Resp. Br., p. 17. Dr. Hekman testified that a reasonable investor would understand "that [the backtest slides] were not 'back-tests' of investment performance." Resp. Ex. 35, p. 14; Tr. 1433. But Dr. Hekman was not offered as an expert on how reasonable investors would understand a slide, nor is there any reason to privilege his opinion on this point over anyone else's. Additionally, Respondents argue that statements made by Lucia at slideshows, and some made during the Webinar, are proof that reasonable investors would understand that the backtests were just hypotheticals using hypothetical rates.

Resp. Br., p. 17. For example, Respondents cite to Lucia's statement, "we know it was more, but we wouldn't have known it at the time," regarding the 3% rate of inflation utilized during the Webinar. Div. Ex. 66, pp. 48-49. Lucia also used the term "pretend" multiple times in the Webinar, and the slideshow contains numerous disclaimers regarding "hypotheticals." Id., pp. 40, 48, 53; Div. Ex. 1, pp. 436, 448, 467. Respondents argue that such statements made it apparent that the backtests were hypotheticals with a forward-looking mentality. Resp. Br., p. 17; Resp. Reply, p. 22 n.29.

Nevertheless, the only two audience members to testify understood from the context that the backtests were presented as historically accurate. Tr. 267-69, 371-72, 377-78. No fine-print disclaimers appear on the slides discussing the '66 Backtest. Div. Ex. 1, pp. 472-78. In the Webinar, Lucia stopped using the term "pretend" after he started discussing the '66 Backtest. Div. Ex. 66, p. 50. The backtests use a mix of historical and ahistorical data, but the results are in every case presented as realistic enough to support substantial investments. Div. Ex. 1, pp. 467-78. Accordingly, I do not find Respondents' arguments regarding a reasonable investor's understanding of the backtests persuasive. That is, a reasonable investor would have understood that the '66 and '73 Backtests' data and assumptions were factual, historical, and realistic.

C. Importance of REITs in the Backtests

Even assuming that a reasonable investor would have understood that some data and assumptions were not realistic, the REIT assumptions are presented misleadingly. I conclude that a major focus of the backtests was to sell REITs, and the backtest slides' misleading statements on REITs were crucial

to Lucia's strategy. Respondents argue that the only purpose of the slideshow, and the backtests, was to demonstrate the effectiveness of the BOM strategy. Resp. Br., pp. 10-11. But selling REITs was at least an equally recognizable purpose. The progression from the "Buttafucco" portfolio to the "Bucketeer" portfolio, that is, from a portfolio that failed to one that succeeded, included only two new variables, BOM and REITs. Div. Ex. 1, pp. 437, 467. The only factor shown to audience members that differed between the backtest slide showing principal of $1.2 million and the following one, showing tripled principal of $4.7 million, was REITs. Div. Ex. 1, pp. 475-78.

Any doubt on this issue is dispelled by the Webinar.[28] In the Webinar, Lucia stresses that REITs, which he generally calls simply "real estate," are "critical" to the BOM strategy. Div. Ex. 66, pp. 34:12-14, 35:10-16. He states that REITs, both tradeable and nontradeable, provide "a higher rate of return at lower risk," which is the "holy grail of investing." Id., p. 35:14-16. He characterizes the "real live" BOM strategy as including twenty percent interest in real estate, while displaying a slide showing "20% REITs." Id., p.

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[28] Respondents place much emphasis on the Webinar, "urg[ing] this court to again review the Webinar prior to issuing a decision." Resp. Reply, p. 17. Respondents offered the Webinar because, they say, it is the only recordation of one of Lucia's slideshows. Resp. Br., pp. 16-17. The Webinar, according to Respondents, shows the full context of the slideshows with discussions that explain the slides that, viewed in a vacuum, are misconstrued. Resp. Br., pp. 16-17. As noted supra, there are numerous differences between the slideshow and the Webinar, some of them significant. Nonetheless, because consideration of the Webinar works almost entirely to Respondents' disadvantage, I accept their invitation to consider it "the best evidence of the BOM seminar presentation." Resp. Br., p. 16.

50:2-5. He emphasizes the value of "nontradeable" real estate, i.e., non-traded REITs. Id., p. 69:17-18. He compares a "pseudo [BOM] strategy," having no REITs, with "the real Buckets portfolio, using real estate, 4.7 million dollars." Id., p. 51:16-19. Plainly, the backtest slides' misleading statements on REITs were crucial to Lucia's strategy.

D. The REIT Rates and Usage were Unreasonable and Misleading

It is undisputed that neither the '66 nor the '73 Backtest meets the definition of "backtest" that I have adopted. Tr. 115-16, 960, 1402; Resp. Br., p. 32. But a prospective investor would have understood the slideshow as presenting the results of backtesting. Given these findings, the spreadsheets do not provide sufficient support for either the '66 or the '73 Backtest, or for the Webinar's version of those Backtests, and the slideshow itself did not provide sufficient transparency to prospective investors regarding either Backtest. More importantly, the various slideshow statements regarding REITs were misleading.

Based principally upon the expert testimony of Grenadier and Gannon, I find that Lucia's use of an assumed 7% dividend rate for the '66 Backtest and 7.75%[29] dividend rate for the '73 Backtest was misleading. First, the '66 Backtest invested in REITs on January 1, 1966, at a time when data on REITs were

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[29] As noted, it is unclear if this was the actual rate used because respondents produced no documentary support for the '73 Backtest numbers. However, the '73 Backtest slide contrasts the Bucketeers against the Buttafuccos, whose portfolio had an assumed 7.75% yearly dividend. Div. Ex. 1, pp. 465, 467. Accordingly, I conclude that a prospective investor attending one of Lucia's seminars would have understood the '73 Backtest to have assumed a 7.75% dividend rate.

unavailable, partly because there was no available index for REITs, but mainly because REITs themselves were largely unavailable. REIT data were unavailable until 1972, six years into the ten-year REIT investments in the '66 Backtest. There is no evidence that Lucia, Plum, or anyone else at RJLC did any sort of analysis like Gannon did for the period 1966-1971. Accordingly, the REIT returns for those years were essentially made up out of whole cloth. Furthermore, the rate that Gannon found with his model was based upon data from a single article, and was heavily burdened with subjective assumptions adopted solely by him. Tr. 1367, 1381. Additionally, as explained supra, even accepting Gannon's assumptions and model, his conclusion actually suggests that REIT dividends (as opposed to IRR) in 1966-1971, had there been any, would have been less than 7%.

Second, whichever index is used, the NAREIT All REIT or the NAREIT Equity REIT, it is clear that 1973 and 1974 produced significant losses for the REIT market as a whole. Div. Ex. 70, Ex. 5a (using NAREIT All REIT); Resp. Ex. 34, Exhibit C (showing NAREIT Equity REIT yearly returns for 1972-2003). Both the '66 Backtest and the '73 Backtest, because they began with REIT investments, would properly have shown substantial losses for any principal investment in 1973 and 1974. Using rates averaged through 2003 ignores the fact that the '66 Backtest invested in REITs in 1966 and held them for ten years, until 1975.[30] Div. Ex. 12. Thus, the principal invested in the stock market in 1975 following liquidation of

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[30] In context, it appears the REITs were purchased at the start of 1966 and sold at the end of 1975, a ten-year period. As noted, it is unclear how long the '73 Backtest held the REITs because no support was produced for it.

the REITs, should properly have been less than $200,000. Gannon's rationale that the dividend rates were reasonable for the period after 1972, because the average rate between 1972 and 2003 was 12.9%, ignores the fact that the REITs in the '66 Backtest were completely liquidated by 1975, leaving only a three-year sample, two of which were disastrous for REITs. Tr. at 1390; Div. Ex. 12.

Third, the '66 Backtest liquidated the REITs after an arbitrary ten years, despite the significant downturn in the real estate market in 1973 and 1974. Gannon testified that average REIT lifecycles last between five and seven years. Tr. 1370. True enough, a REIT could have a ten-year cycle, but according to Gannon's testimony, that would occur outside the norm. Tr. 1369-70. It was also convenient for Respondents to use a ten-year cycle. Liquidating anywhere within the five to seven year period would have exposed that principal to the Grizzly Bear Market for stocks – an asset which Lucia was actually calculating using historical returns. Instead, the ten-year period allowed Lucia to time the market perfectly, investing in the stock market as it rose again. Without liquidity events, there are few options to liquidate non-traded REITs, other than redemption for a discount to the principal investment. Tr. 1298-99, 1675. The assumed timing for the liquidity of the REITs in the '66 Backtest was, thus, unreasonable and its effect on the final number presented to prospective investors contributed to the backtest slide being misleading.

Fourth, the '66 Backtest as presented in the slideshow discloses neither the length of time REITs were assumed to have been held, nor whether the REIT principal remained constant. Div. Ex. 1, pp.

471-78. The Webinar was similarly silent on these assumptions. Div. Ex. 66, pp. 48-50. A prospective investor would not have known either how long the REITs were assumed to have been held, or the ending REIT principal amount.

Fifth, the Webinar is even more misleading than the slideshow. The first "Notes & Disclaimers (REITS)" slide in the slideshow does not appear in the Webinar at all, and although the second "Notes & Disclaimers (REITS)" slide appears in the Webinar, it does not disclose the fact that REITs have limited liquidity, in contrast to the corresponding slide in the slideshow. Div. Ex. 1, pp. 415, 447; Div. Ex. 66, pp. 35, 44. Before discussing the effects of REITs in connection with the '66 Backtest, Lucia repeatedly uses the term "pretend" when introducing his assumptions. Div. Ex. 66, pp. 40, 48. But when he discusses the effects of REITs, he does not use the term "pretend." Id., p. 50:5. When discussing the BOM strategy in detail, Lucia states "in the sixties, you could have got about $15,000 per year income, dividends from that real estate investment." Id., p. 44:22-25. This assumes a 7.5% dividend, which as noted supra, is false, and in context it is extremely misleading because it affirmatively avers that REITs were available for investment in the 1960's. Respondents' argument that the BOM strategy outperformed the comparative portfolios, "even assuming the actual historical rates were applied" to the '66 and '73 Backtests, is thus entirely unpersuasive. Resp. Br., p. 17.

E. The Inflation Rate Used was Unreasonable and Misleading

I find that Respondents' use of a 3% inflation rate, and failure to disclose that a historical rate would

have depleted the backtest portfolios after a short period, were misleading. A flat 3% rate was much lower than average rates during the times of the backtests, and such a downwardly-adjusted rate allowed the backtest portfolios to avoid running out of money far sooner than presented.

Grenadier testified that CPI-U is the "most common standard ubiquitous version of inflation data there is." Tr. 937-38. CPI-U, reported by BLS, indicates that historical inflation rates during the backtest periods were significantly higher than 3%. Div. Ex. 70, Exs. 2a-2c. During the late 1970s and early 1980s, CPI-U reached levels as high as 13.5%. Id. Seminar attendees were not advised that the inflation rate used was far below historical numbers and that use of even modified historical rates, accounting for biases, would have caused the backtest portfolios to drop to a zero balance years prior to 2003. OCIE calculated that the average inflation rate between 1966 and 2003 was 4.8%, much higher than the static 3% rate used in the backtests. Tr. 111. Grenadier verified that substituting historical CPI-U rates year by year into the backtests would cause the '66 Backtest to have a zero balance after 1986. Div. Ex. 70, pp. 8-9, Exs. 2a, 2c; Tr. 934-35. Annual CPI-E rates, which are readily available for 1982 through the present, and are purportedly reflective of inflation rates for elderly consumers, would also have resulted in the '66 Backtest going bankrupt in 1986. Div. Ex. 70, Ex. 3a.

Furthermore, as Grenadier noted, using a 3% average rate was misleading because the periods of higher inflation occurred early in the backtest periods, and use of historical rates would have rapidly reduced

principal balances. Tr. 941. Withdrawing significantly more income to keep up during the high inflation years would deplete assets much more quickly, and the remaining balances would have less room to grow, exacerbating losses. Tr. 941. None of these facts were disclosed to seminar attendees.

Respondents argue that CPI-U, and even CPI-E, are not reflective of inflation rates for retirees and elderly people because they tend to spend less as they age. Tr. 1175-77, 1290. Lucia bases his understanding of this concept in part on anecdotal evidence of his 87-year old father's diminished spending. Tr. 1186, 1291-92. This argument incorrectly conflates spending levels with inflation. CPI is determined, in essence, by comparing a basket of goods from a reference period to the fixed basket of goods at a measured time. Resp. Ex. 39, p. 5, Tr. 939. As Grenadier pointed out, the fact that people over the age of 65 tend to spend less "has nothing whatsoever to do with inflation." Tr. 971. As Grenadier went on to say, if Respondents wanted to reflect lower spending by retirees, they could have designed an example factoring in diminished consumption. Tr. 971. There is no evidence that Respondents marketed the BOM plan as one that survives retirement based upon the expectation that investors will spend less as they get older. Instead, they unequivocally presented the backtests as providing a steady inflation-adjusted income without regard to actual spending. Div. Ex. 1, pp. 422-24, 472; Resp. Ex. 30; Div. Ex. 66, pp. 11-12, 39. Additionally, as Grenadier testified, CPI-E was actually higher on average than CPI-U during the backtest period, which indicates that inflation levels for elderly consumers are

higher than for the non-elderly and weakens Respondents' argument that inflation rates are lower for elderly consumers. Tr. 940.[31]

Hekman's analysis, accounting for the fact that CPI-U purportedly overstated inflation by 1.2% (between 1966 and 1996) or 1% (from 1996 forward), provides little help to Respondents. Resp. Ex. 35, pp. 10. Even with these modified CPI-U rates, the '66 Backtest would have gone bankrupt after 1993. Resp. Ex. 35, Appx. 10. By 1980, when inflation peaked at 13.5%, Hekman's calculations, even with the 1.2% CPI-U haircut, left the portfolio with $916,388—more than $100,000 less than in the '66 Backtest. Div. Ex. 12; Resp. Ex. 35, Appx. 10. Regardless of how CPI-U was calibrated, there were years of very high inflation, and using 3% for those years was, by itself, unreasonable for the backtests.

Hekman engaged in a separate analysis factoring a 2% reduction in spending for retirees each year in addition to the 1.2% CPI-U haircut, which he based

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[31] Respondents claim that CPI-E is flawed because, among other things, it places significant weight on housing. Tr. 881-82, 1177, 1290-91. Hekman argues that the use of housing in the basket of goods is flawed because 80% of people over age 60 own their homes and 65% own them free and clear of a mortgage. Resp. Ex. 35, p. 10. It may be that CPI-E places too much emphasis on housing, but no evidence was submitted during the hearing to suggest that inflation rates, even for the elderly, averaged as low as 3% for the period between 1966 and 2003. Moreover, the 1995 release published by BLS on CPI-E, to which Hekman cited, explains that inflation had risen more rapidly for elderly that non-elderly consumers between 1990 and 1995, based upon a rise in prices among four of the seven largest spending categories in the consumption basket. Resp. Ex. 35, Attachment F. A major factor for this increase is the rapidly rising costs of medical care. Id. I am therefore not persuaded that the inflation rate for seniors is considerably lower than CPI-U.

upon cited studies. Resp. Ex. 35, Appx. 11; Tr. 1418. His analysis shaved an additional 2% off the 1.2% haircut to CPI-U he provided in his prior analysis, effectively providing a 3.2% decrease to CPI-U. Resp. Ex. 35, Appx. 11. This modification led (unrealistically) to negative inflation rates for certain years and a resulting balance of over $6.6 million in 2003. I do not find this argument particularly persuasive because, again, this was not what was presented to attendees, which is especially apparent due to the significantly higher ending balance than Respondents presented. Furthermore, even assuming a 3.2% decrease to CPI-U, the rate during the late 1970s and early 1980s would still have been much higher than 3%. For example, as Hekman's table provides, the rate in 1980 with these deductions was still 10.3%. Resp. Ex. 35, Appx. 11.

True enough, seminar attendees would understand that a flat 3% rate did not reflect year-by-year historical rates, especially because attendees were mostly retirees and near-retirees who lived through the tumultuous high-inflation years of the late 1970s and early 1980s, and would understand that inflation varies year to year. The attendees would have understood that the inflation rate for the early years of the backtests was not a static rate, but that use of a flat rate was intended to reflect an average. DeSipio testified that he was aware that the backtests used an average rate. Tr. 267. Furthermore, Lucia provided some context to the fact that the inflation rate did not track precise historical rates. For example, Lucia stated during the Webinar, regarding the inflation rate used for the '66 Backtest: "And let's pretend that from that point forward, inflation was 3 percent. We knew it was more. But we wouldn't have known that at the time." Resp. Ex. 30; Div. Ex. 66, pp. 48-49. This

single statement, assuming it was repeated regularly at seminars, let attendees know that the flat rate he used for the '66 Backtest was lower than historical inflation. Despite this limited disclosure that the rate used was not historically precise, seminar attendees did not know how far below historical numbers the 3% rate was. More importantly, they were never made aware of the crippling impact historical numbers would have on the backtests.

Whether it was appropriate to use an average rate or even an approximation in a backtest is not the crucial issue here. The fact that the '66 Backtest portfolio would have depleted its assets approximately 17 years before 2003, when it supposedly produced high balances, was misleading because Respondents, as Lucia admitted, regularly marketed the strategy as one that provides "inflation-adjusted income for life." Div. Ex. 8, p. 4; Tr. 741-42, 1082-83. Reasonable investors could not glean from the slideshow that the inflation rate used was completely disconnected from historical reality. Understanding that the inflation rates were completely ahistorical, and would bankrupt the backtest portfolios, would, as Chisholm testified, alter potential investors' confidence in the strategy. Tr. 364, 373. As Grenadier explained, the use of a fixed 3% inflation rate during the backtest period gave Respondents "the benefits of inflation but not the costs." Tr. 941.

Hekman provided evidence that many large financial institutions and the U.S. Government, among other entities, use a 3% inflation rate for retirement planning. He raises this point to argue that Respondents acted reasonably in using a 3% inflation rate. Resp. Ex. 35, pp. 4-5. I have no reason to doubt that

these institutions' projections are reasonable, as Hekman asserts. Indeed, courts are reluctant to admit expert testimony predicting future inflation, finding it an abuse of discretion. See, e.g., Taenzler v. Burlington Northern, 608 F.2d 796, 801 (8th Cir. 1979) ("Such testimony may present as an estimate a specific rate of future inflation more precise than present knowledge warrants."). Hekman's analysis in this regard misses the point, however, as he focuses upon what institutions project for future inflation levels. Hekman's and Respondents' argument in this regard hinges entirely on the assumption that the backtests were not backtests; rather, they were forward-looking projections. Lucia, as discussed, supra, did not offer projections. Instead, he offered carefully crafted backtests regarding performance of hypothetical BOM portfolios through historical periods.

Respondents argue that the BOM seminars were designed to show only that BOM would work better than the hypothetical investor portfolios that were compared to the backtests. Accordingly, Respondents argue, there was no performance advertising and the inflation rate was irrelevant as long as the methodology was consistent. Resp. Br., p. 43; Tr. 800. In fact, the methodology was not always consistent. As discussed, supra, the presentation introduced important variables into the backtests that were not used with the earlier hypothetical investors. The Balanced Buttafuccos maintained a simple 60/40 stock and bond portfolio, but the backtested Bucketeer portfolios included other items, most notably, REITs. Div. Ex. 1, p. 476; Resp. Ex. 30; Div. Ex. 66, p. 50. Additionally, the backtested portfolios migrated from pre-established return rates in the earlier hypotheticals, including the 10% assumed stock return rate and a 5.5% rate for bonds and CDs for the first Bold Bucketeer

hypothetical, to a historical stock return for the first two years and unknown bond returns in the '73 Backtest. Div. Ex. 1, p. 465; Resp. Ex. 30; Div. Ex. 66, p. 43. Most significantly, the '66 Backtest involved a stocks-only asset allocation beginning in 1980, when inflation peaked. Div. Ex. 12; Resp. Ex. 35, Appx. 10. Lucia stated in the Webinar that only "stock and/or real estate" would hold its value after taxes and inflation, which is why he recommended a "commitment to the stock market" to "manage the risk of inflation." Div. Ex. 30; Div. Ex. 66, pp. 11-12. But at no point does the Webinar (or the slideshow) disclose that that commitment in the '66 Backtest was total. Respondents' abandonment of the BOM strategy did not present a consistent methodology and artificially bolstered at least the '66 Backtest results. In essence, Respondents were comparing apples and oranges without disclosing that fact to seminar attendees.

Respondents point to brochures by American Funds, Fidelity, and Financial Engines Income+ as evidence of industry standards on backtests and use of averaged inflation rates in the backtests, which, they claim, shows that their use of a flat 3% rate was reasonable. Resp.. Exs. 46, 47, 59; Resp. Reply, p. 19-21. Their reliance on these brochures is misguided. The Fidelity brochure provides no insight into the exact inflation rates used, but makes clear that the withdrawal rates were inflation adjusted. Resp. Ex. 47. The Financial Engines Income+ brochure states, for what Respondents claim to be a backtest, that payout amounts rose on an annualized basis 2.4%. Resp. Ex. 59, p. 19. A close read, however, makes clear that annual payouts in its hypothetical portfolio increased by 254% from beginning to end, according to increases from investments, which it noted was a 61% increase after factoring in inflation. Id. 2.4% refers simply to

the average amount that payouts exceeded the inflation rate over twenty years. Id. American Funds' use of a 4% inflation rate, though an average, is still higher than the 3% Respondents used. Resp. Ex. 46.

F. Failure to Deduct Fees or Disclose Their Omission was Materially Misleading

The failure to take fees into account in the slideshow was misleading. As Grenadier wrote, "Implementation costs for a strategy are important because they may reduce, and at times eliminate, the benefits of a particular strategy." Div. Ex. 70, p. 13. That is certainly true of the backtested portfolios, and seminar attendees were unaware of how significantly the costs would eat away at the purported backtest results. Attendee witnesses DeSipio and Chisholm corroborated this fact. Tr. 289, 374.

The allusions to fees in the slideshow and in the Webinar are insufficient. Fees are discussed in only four areas in the slideshow: a generic legal disclaimer, general advice to try to keep fees low, general REIT disclaimers, and a footnote to a prepackaged Ibbotson slide used to tout diversification into real estate. See Div. Ex. 1, pp. 360, 415, 416, 447, 479. None of these pertain specifically to the backtests, and, in context, they are far too vague and general to constitute disclosure that fees were not deducted in the backtests. The only additional discussions of fees during the Webinar, which Lucia casts as representative of his full seminars, come during the explanation of mutual funds and in connection with an illustration of Lucia preparing a bucket portfolio on himself.[32] Resp. Ex.

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[32] It is worth noting that this discussion of mutual funds was part of Respondents' chastisement of a set of analysts' mutual fund buy and sell picks, which, Lucia says, would have lost

30; Div. Ex. 66, pp. 24, 62; see also Resp. Br., p. 16. Each is completely unconnected from the backtest discussions.

Respondents concede that advisory fees materially affect a portfolio's returns. Tr. 1199, 1203, 1285. Just as Respondents used proxies for the stock market and the bond market, using the S&P 500 and T-Bills, respectively, Respondents could have determined applicable fee proxies, much like Grenadier did in his expert report. See Div. Ex. 70, pp. 13-14, Exs. 6a-6b; Tr. 945. Respondents' argument that fees were difficult to predict because they were charged inconsistently, and sometimes not at all, is not credible. Tr. 1285, 1564, 1664-65; see also Resp. Reply, pp. 36-37. Respondents were surely acutely aware of the advisory fees, transaction costs, commissions, and management fees charged to clients. Tr. 1654-56, 1664-65. Respondents also received trailing commissions on certain products, including mutual funds. Tr. 1656. All of these fees, which produced a substantial portion of RJLC-affiliated companies' income, were tracked. Tr. 1656-57. Respondents had the capacity to estimate approximate fees for products that behaved like the S&P 500 index and conservative bonds, like they used in the backtests.

Respondents refer to the Fidelity, Financial Engines Income+, and American Funds brochures, which allegedly describe backtests similar to Respondents'. Resp. Reply, pp. 18-20; Resp. Exs. 46, 47, 59. These brochures do not help Respondents. The Financial

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money on the returns "minus .75%" – alluding to what I can only infer is a set of fees Respondents felt comfortable with as an average. Div. Ex. 66, p. 24. It seems Respondents are comfortable including fees when it helps illustrate their point, but not when it hurts it.

Engines Income+ brochure notes that estimated fees were included in the calculations, despite the fact that the portfolios included generic market-trending products, much like Respondents offer in the backtests. Resp. Ex. 59, p.18. This example severely weakens Respondents' argument that it would have been impossible and, indeed, misleading to include estimated fee levels. Fidelity did not include fees in their withdrawal rate hypothetical, but specifically disclosed that the backtested portfolio was not net of fees and that fees would significantly impact the portfolio. Resp. Ex. 47, p. 4. It is unclear whether the first chart in the American Funds brochure is net of fees. Resp. Ex. 46, p. 1. The second chart, using specific American Funds products, is specifically described as reflecting "net asset value." Resp. Ex. 46, p. 2.

The failure to take fees into account was also misleading because, as with inflation, the slideshow compared apples and oranges. Focusing just on the most pertinent thirteen pages of the slideshow, there are four scenarios: a first scenario (the '73 Backtest), in which the previously-described Bold Bucketeer portfolio (a 40-20-40 split between stocks, bonds, and REITs) is modified somewhat and then assumed to start in 1973 (Div. Ex. 1, pp. 466-68); a second scenario within the '66 Backtest, which assumed a 60-40 split between stocks and bonds and no use of the BOM strategy (Div. Ex. 1, pp. 469-73); a third scenario within the '66 Backtest, similar to the second scenario but using the BOM strategy (Div. Ex. 1, pp. 474-75); and a fourth scenario within the '66 Backtest, similar to the third scenario but with a 40-20-40 split between stocks, bonds, and REITs (Div. Ex. 1, p. 476-78). As noted, Div. Ex. 12 supports the calculation for the fourth scenario, but there is no support for the other

three, and Hekman could not recreate the slideshow's results for the first scenario. Tr. 802, 811, 1535-37.

Had these four scenarios been fairly comparable, the lack of fee disclosure might not have been misleading to prospective investors. For example, had all four scenarios maintained a 60-40 stock/bond split, had fees been some fixed percentage, and had the results been reported net of fees, the portfolio results would all presumably have been numerically lower, but the BOM strategy plus REITs may have performed better, all else equal, than not using BOM or not including REITs. But the four scenarios were not fairly comparable. Instead, two scenarios had REITs and two did not, at least two scenarios (the first and fourth) definitely did not rebucketize, one scenario (the fourth) ended up fully invested in stocks after 1980, and the third scenario may or may not have rebucketized. Resp. Br., p. 51. Because of the different asset allocations, both initially and over time, it cannot be assumed that fees would have been irrelevant. If fees are different for different assets, the overall fee load for the four scenarios will be different. It is a misleading oversimplification to assume, as Respondents essentially did, that the effect of fees is a wash.

Finally, Respondents argue that failure to include fees in the backtests is of no consequence because fees are fully disclosed when potential investors meet with an RJLC adviser. The Division does not allege that RJLC advisers failed to provide full disclosure concerning fees to potential investors, and I have no reason to doubt that they did. What is at issue, however, is whether it was misleading to fail to include fees or disclose their absence in the backtests. They did nei-

ther. After-the-fact disclosures, when potential investors meet with advisers, do not render the slideshow not misleading.

G. Failure to Disclose That the Backtests Were Not Rebucketized Was Misleading

The OIP alleges that Respondents "failed to reallocate assets after the bond and REIT buckets were exhausted" as to both backtests. OIP, p. 8. Failure by Respondents to disclose that the '66 Backtest portfolio (the fourth scenario, supra) remained completely invested in the stock market after the first fourteen years was misleading to seminar attendees. Although it is unclear from the slideshow whether there was or was not rebucketizing in the '73 Backtest, Respondents concede that there was no rebucketizing. Div. Ex. 1, p. 467; Resp. Br., p. 51. I find this failure to be misleading, as well.

The continuous message throughout the seminar presentation was that portfolios were structured to ensure there was always a safe bucket for withdrawals. This is evident both in the slideshow text, particularly the hypothetical investor illustration progression, and from the conversations that accompanied the slides, as shown by the Webinar. Respondents admit that they did not show any spreadsheets to seminar attendees to demonstrate where the buckets were allocated after the REITs and bonds were depleted. Tr. 1149. Nor did Lucia inform attendees, as part of the seminar, that the '66 Backtest portfolio was invested entirely in the stock market after 1980. Tr. 1131. Thus, seminar attendees did not have actual knowledge that the entire '66 Backtest portfolio was allocated to the stock market for over half of the portfolio lifespan.

The context of the slideshow suggested to seminar attendees that rebucketizing happened. The first BOM illustration for the Balanced Buttafuccos follows a twelve-year progression through which the investors withdrew income from buckets 1 and 2, representing safe and moderate-risk investments, plus the dividends from a REIT investment. Div. Ex. 1, pp. 448-461. Following those first twelve years, the first and second buckets are depleted, and the next slides show how the third-bucket assets, the REITs and a stock portfolio, grew from $562,000 to $1.4 million. Id., pp. 461-65. The conclusion on the "Buckets Overview" slide is that this $1.4 million bucket is available to "Re-Bucketize for another 12 years." Id., p. 465. The next set of slides, the '73 Backtest, purports to show that following a similar portfolio begun in 1973 would provide over $1.5 million after twenty-one years. Id., p. 467. Respondents concede there was no rebucketizing, but the slideshow suggests that Respondents followed the same methodology as before, that is, there was rebucketization. Lastly, the '66 Backtest portfolio purports to be a "Buckets of Money Portfolio," suggesting that it rebucketizes. Id., pp. 474-78.

Despite touting the power of the stock market generally, Lucia clearly advised attendees against exposing an entire portfolio to the stock market, which would lead reasonable investors to assume that Lucia would not leave a BOM portfolio completely in stocks. Lucia stated early in the Webinar, after extolling the general virtues of the stock market:

> So when you look at a slide like this, you've got to ask yourself, why wouldn't I put a hundred percent of my money into the stock mar-

> ket. And that's why [introducing slide illustrating high stock market volatility]. When you look at the volatility of the stock market, you see violent swings up and violent swings down. Don't need to explain to anybody about the violent swings down, because we certainly have experienced, what, a forty-percent decline in the last year.

Resp. Ex. 30; Div. Ex. 66, p. 7. Moreover, leading up to the introduction of the first BOM portfolio, the slideshow emphasizes the potentially disastrous possibilities of investing completely in the stock market. Lucia describes the High Rolling Hendersons, who invested completely in the stock market. Div. Ex. 1, pp. 427-432; Resp. Ex. 30; Div. Ex. 66, pp. 40-41. In one scenario, they received high returns. However, when the Hendersons begin their stock market investment in a bear market in 1973, the slideshow demonstrated that they go broke within seventeen years. Div. Ex. 1, p. 432; Resp. Ex. 30; Div. Ex. 66, p. 41. It recapitulates these poor results by discussing how stock market investments in 1973 took 12.8 years to equal the returns of T-Bills. Div. Ex. 1, pp. 429-31; Resp. Ex. 30; Div. Ex. 66, pp. 40-41.

Lucia testified that in addition to his oral discussions, he provided hand-drawn illustrations, which made clear to attendees how rebalancing would happen "in real life." Tr. 1187-89. There was nothing in the Webinar, however, to suggest that there was dialogue in the seminars to clue attendees into the fact that the '66 Backtest was not rebucketized, or that it was invested completely in the stock market for the majority of the backtest period. During the Webinar, Lucia made clear that the foundation of BOM was to

maintain diversity and to draw money from safe accounts over riskier accounts, emphasizing that there should be asset classes that do not "correlate positively all the time." Resp. Ex. 30; Div. Ex. 66, p. 34. Hearing BOM axioms like this, seminar attendees would not infer that the '66 Backtest left the entire portfolio in the stock market and drew income from it for fifteen to twenty years.

The Webinar is not helpful to Respondents on this point. Lucia said in the Webinar, "you never drain that stock portfolio for income." Resp. Ex. 30; Div. Ex. 66, p. 35. Lucia also quoted from an article by John J. Spitzer and Sandeep Singh titled, Is Rebalancing a Portfolio During Retirement Necessary? Tr. 1188; Resp. Ex. 37. He stated, "[w]ithdrawing the bonds first over stocks, performs the best . . . [t]his method, my little Buckets of Money method . . . also is most apt to leave a larger remaining balance at the end of thirty years." Resp. Ex. 30; Div. Ex. 66, p. 30 (internal quotations omitted). After the standard slideshow ended in the Webinar, he discussed additional hypotheticals, one of which assumed living off dividends from annuities and REITs, in addition to dividends from equity. Resp. Ex. 30; Div. Ex. 66, p. 66. A second hypothetical solves the problem of the stock market hypothetically imploding after fifteen years by taking REIT money that is still in the portfolio and replenishing the first two buckets. Resp. Ex. 30; Div. Ex. 66, p. 66-67. A third hypothetical posits that after fifteen years there is still money in the REIT bucket. Resp. Ex. 30; Div. Ex. 66, pp. 61-65. That seminar attendees "would have been informed at some point in the seminar that rebalancing wasn't necessary," is insufficient to render the backtests not misleading, because that infor-

mation was overwhelmed by the message that rebucketizing was part of a successful BOM strategy. Tr. 1188-89.

The attendee witnesses both testified that they understood BOM to require rebucketizing. Tr. 250, 357. DeSipio testified that he understood "[t]he whole idea was once you use your first bucket up, you took the . . . money from the second bucket and used that – poured that into the first bucket . . . then [when the second bucket was exhausted], you'd be using the third bucket to replenish the previous buckets going forward." Tr. 250. Chisholm testified that he understood that "it was imperative for [BOM] to work that you rebucketize . . .. It is what [BOM] was all about." Tr. 357. Chisholm went on to testify that he assumed the backtests were rebucketized because "that is what [BOM] is all about, to rebucketize, to reallocate, to draw down, to continuously replenish. I had no reason to believe he would not." Tr. 375. A reasonable investor would have been misled by the failure to rebucketize.

H. Misleading Impact of Historical Context

Respondents used the 1973 and 1966 retirement start dates in the slideshows to provoke sentiment in audience members who were predominantly retirees and near-retirees. These historical start dates were not arbitrary. Respondents assert that the Backtests were merely "forward-looking" hypotheticals to show BOM's efficacy. Resp. Br., p. 14. I disagree. To accept that argument discounts Respondents' calculated use of specific historical milieus. If Respondents' only goal was to demonstrate that BOM portfolios outlast conventional portfolios under any set of market conditions, start dates of 1973 and 1966 were not required,

nor would there be any reason to mix actual market with assumed market data.

The slideshow prefaces the backtests with historical context of the poor economic conditions plaguing the stock market from 1966 to 1982 and the acute problems in the market during 1973 and 1974. Div. Ex. 1. The presentation further primes the audience by representing how the non-bucketized – and non-REIT-invested – fictional investors would have fared, had they retired on January 1, 1966, and January 1, 1973. Id., pp. 471, 478. Many audience members who were retirees and pre-retirees would have lived through the market stagnation in the 1960s and the bear market in 1973-74. DeSipio understood the backtests to mean that the portfolios "held up under the various market conditions that occurred over the years." Tr. 268. Chisholm said, "It was my understanding that [the bear markets] would not be an issue because this was a proven method of investing, that it had been back-tested." Tr. 358.

I. The "Backtests" were not Merely "Hypotheticals"

Respondents argue that their use of the term backtest is scrutinized unfairly, and that what they offered were merely a series of "hypotheticals." Resp. Br., pp. 10-14, 32. Respondents support this argument by noting that the term "backtest" is only used twice in the slideshow; whereas, "hypothetical" is used thirty-seven times. Resp. Br., p. 32, n.38. Respondents also argue that, in hindsight, they would have used the term "hypothetical" instead. Resp. Br., p. 32. I do not find this convincing. Foremost, a backtest is, by definition, a realistic hypothetical. Tr. 115. Otherwise, there would be actual historical statistics for the actual portfolio. Similarly, the number of times

the terms are used does not diminish the emphasis on what the backtest slides represented: the grand culmination of the slideshow, hailing the triumph of the BOM portfolios, with REITs, over all of the fictional investors' portfolios. For the reasons discussed supra, the slideshow would be misleading even if the term backtest never appeared in it. The use of the term backtest by itself does not make the slideshow misleading – it only exacerbates it.

J. The Backtests were Misleadingly Offered as Scientific Findings

Respondents coated the backtest slideshows with the veneer of scientific methodology and due diligence. For example, Lucia stated during his Webinar that he told his friend Ben Stein, "You'd lose all respect for me if I hadn't done my homework. I have." Div. Ex. 66, p. 48. Lucia also began the Webinar by stating, "I'm going to show you the science behind retirement distribution planning, not really focusing on the art of speculation. There's a big difference between science – that which has been proven in finance labs all around the country – and art, which is, I don't know, pulling stuff out of the sky and trying to figure it out from there." Id., p. 4. Such language implies that Respondents applied proper diligence to prove that the strategy would endure the market conditions of the 1960s and 1970s. Despite what Lucia represented about backtesting to 1973 and 1966, he actually had insufficient support for the backtests. Even the minimal support produced by Plum includes arithmetical errors. Tr. 667, 1079-80; Div. Exs. 12, 13. RJLC had no procedures in place to determine whether calculations were accurate. Tr. 668. There is no evidence that anyone verified the numbers generated by Lucia's daughter's boyfriend, a recent college graduate.

Tr. 784. In sum, Lucia did, in fact, "pull[] stuff out of the sky." Div. Ex. 66, p. 4.

K. The Clients' Testimony Was Credible

Respondents argue that the testimony of the two RJLC clients, DeSipio and Chisholm, should be discounted. Resp. Br., pp. 52-54. DeSipio filed a Financial Industry Regulatory Authority (FINRA) arbitration claim which contained false allegations against Lucia, having to do with a mortgage-backed investment but not the BOM seminars. Tr. 318-19. He ultimately released Lucia from the case and admitted in writing that his claims against Lucia were false. Tr. 319. Because I sustained the Division's objection to four proposed exhibits pertaining to the FINRA claim, the precise nature of the claim and release are unclear. Tr. 309-12. In particular, there is no evidence that DeSipio's claim was verified, or that he made any knowingly false sworn statements in any filings in the FINRA case. Accordingly, the fact that his FINRA claim made false allegations reduces DeSipio's credibility somewhat; on the other hand, the fact that he released Lucia from the case and admitted that his claims against him were false, apparently without any consideration, restores his credibility somewhat. Overall, DeSipio's testimony was straightforward, with essentially no evasiveness, and his demeanor was sincere. I do not discredit any of his pertinent testimony.

Respondents also denigrate Chisholm's credibility based upon his failure to remember the precise order of when he attended BOM seminars and when he first met with an RJLC advisor. Resp. Br., p. 54 & n. 72. Chisholm initially testified that he invested with RJLC after seeing a BOM presentation in late 2009 or 2010. Tr. 434. However, Chisholm admitted during

cross-examination that he may have been influenced to invest through RJLC due to a show he attended in 2006, rather than the second one he attended in 2009 or 2010. Tr. 416. Or, alternatively, Chisholm was influenced to invest in REITs through RJLC based upon a combination of having seen the slideshow presentation, reading Lucia's books, and hearing his radio show. Tr. 336, 339, 1632. Admittedly, the holes in his memory would reduce his credibility if the timing of various events were crucial. But because Lucia offered the same backtest claims through all the media he used, I find it irrelevant whether Chisholm was mistaken about having contacted RJLC before or after the latest slideshow he attended. Even assuming that Chisholm became a client of RJLC after calling Lucia's radio show and asking to speak with a representative – as Lucia, Jr. testified, without any explanation for how he knew such facts – it is undisputed that Chisholm attended a BOM seminar prior to calling into the show. Tr. 1632. Respondents' argument that Chisholm became a client of RJLC "as a result of Lucia's radio show, not a BOM seminar" is not a reasonable inference from these facts. Resp. Br., p. 54, n. 72. Nor am I impressed by the fact that Chisholm has complained to multiple people about the REIT investment he made through RJLC, but not about the BOM seminar; to the contrary, that he complained to others actually bolsters his overall credibility, and that he complained only about his REIT investment actually supports the finding that Respondents had an overwhelming incentive to sell REITs, even to clients for whom they were not appropriate. As with DeSipio, I do not discredit any of Chisholm's pertinent testimony.

IV. CONCLUSIONS OF LAW

A. Sections 206(1) and 206(2) of the Advisers Act.

RJLC violated Sections 206(1) and 206(2) of the Advisers Act.[33] Section 206 provides:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly – (1) to employ any device, scheme, or artifice to defraud any client or prospective client; (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

15 U.S.C. § 80b-6. To establish violations under sections 206(1) and (2) of the Advisers Act, the Division must prove that RJLC was an investment adviser, that it engaged in fraudulent activities by jurisdictional means, and that it negligently breached its fiduciary duty by making false or misleading statements or omissions of material fact. SEC v. Merrill Scott & Assoc., Ltd., 505 F. Supp. 2d 1193 (D. Utah 2007); SEC v. Gotchey, No. 91-1855, 1992 WL 385284, *2 (4th Cir. Dec. 28, 1992); See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963). To establish a violation of Section 206(1), the Division

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[33] RJLC was the "maker" of the fraudulent statements under Janus Capital Group, Inc. v. First Derivative Traders, 131 S.Ct. 2296, 2302 (2011), because it "created" the materials and had ultimate legal control and responsibility for them. Tr. at 457. Lucia's statements and actions as the controlling and sole shareholder were offered as part of RJLC's marketing, and thus are imputed to RJLC.

must also prove that Lucia and RJLC acted with scienter. SEC v. Steadman, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992).

1. Registered Investment Advisers and Interstate Commerce

RJLC was a registered investment adviser from 2002 to 2011. RJLC Answer, p. 1. Lucia became a registered investment adviser in 1996 and, at least at the time of his Answer, was still a registered investment adviser. Lucia Answer, p. 2; Div. Ex. 2, p. 5. Lucia and RJLC engaged in interstate commerce. Lucia presented his slideshow to audience members and prospective investors across the country, visiting different cities around forty times a year. Tr. 1059, 1069-70. RJLC was a countrywide investment adviser, with at least fifteen offices in multiple states, including California, New Jersey, and Oregon. Tr. 280, 383, 1304.

2. Misrepresentations

Lucia and RJLC misrepresented the veracity of the backtests by using a misleading mix of historical and ahistorical information. The Division showed that Respondents provided misleading information about having backtested the information and that Respondents omitted material information about the assumptions used for the backtests.

Respondents misled prospective clients by portraying their conclusions as having been actually backtested and that the backtests used scientific methodology with realistic historical data and assumptions. Using that backdrop, Respondents misleadingly portrayed the '73 Backtest conclusion that, after twenty-one years, the fictional investors would maintain $1,544,789 in principal, as empirical proof of

the veracity of BOM with REITs. Nevertheless, Respondents were unable to provide any support for the '73 Backtest and their own expert could not recreate the '73 Backtest results.

Similarly, Respondents misleadingly presented to seminar audiences that they had backtested the BOM strategy to 1966, and that the BOM strategy, with the addition of REITs, culminated in a $4.7 million portfolio for the fictional investors. The spreadsheets offered as support in conjunction with actual historical data on REITs show that the conclusion offered in the slideshows was inaccurate and misleading because the REIT rate utilized was historically inaccurate and inflated, the REITs were invested at a time when they were unavailable, the REITs' liquidity was never impaired despite undisputed evidence that it would be, stable REIT investments were artificially assumed to have been made during the stock market drops in the early and mid-1970s, and the calculations were flawed and incorrect. The same is true of the backtests' use of a misleadingly low inflation rate, undisclosed exclusion of fees, and the failure to disclose that the backtests did not follow the BOM plan as advocated, which would have included rebucketizing and ensuring that the portfolios were not allocated completely to stocks.

Finally, the Commission is not required to prove reliance in an enforcement action and the lack of reliance is, therefore, not a defense. See e.g. SEC v. Simpson Capital Mgmt., Inc., 586 F. Supp. 2d 196, 201 (S.D.N.Y. 2008) ("Unlike private litigants, the SEC is not required to prove investor reliance . . . in an action for securities fraud."); SEC v. Rana Research, Inc., 8 F.3d 1358, 1363 & n.4 (9th Cir.1993); SEC v. Blavin, 760 F.2d 706, 711 (6th Cir.1985).

3. Scienter

Scienter is defined as a "mental state embracing the intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); Aaron v. SEC, 446 U.S. 680, 686 n.5 (1980). A finding of recklessness satisfies the scienter requirement. David Disner, 52 S.E.C. 1217, 1222 & n.20 (1997); Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1568-9 (9th Cir. 1990), cert. denied, 499 U.S. 976 (1991) (citing eleven circuits holding that recklessness satisfies scienter in Section 10(b) and Rule 10b-5 actions). Recklessness, in the context of securities fraud, is "highly unreasonable" conduct, "which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1977) (quoting Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1978)); see also S.W. Hatfield, CPA, Exchange Act Release No. 69930 (Jul. 3, 2013), 2013 WL 3339647 at *21.

The standard of care for a registered investment adviser is based on its fiduciary duty. See Transamerica Mortg. Adviser, Inc. v. Lewis, 444 U.S. 11, 17 (1979); Capital Gains Research Bureau 375 U.S. at 191-92. Investment advisers have an "affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts.'" Capital Gains Research Bureau, 375 U.S. at 194 (citations omitted); Blavin, 760 F.2d at 711-12. Respondents were required to "employ reasonable care to avoid misleading" clients. See Capital Gains Research Bureau, 375 U.S. at 194; SEC v. Moran, 922 F. Supp. 867, 895-96 (S.D.N.Y. 1996). Ultimately, the standard is one of "reasonable

prudence, whether it usually is complied with or not." Vernazza v. SEC, 327 F.3d 851, 861 (9th Cir. 2003) (citation omitted). As applicable here, an investment adviser has a "professional duty to investigate the information upon which his recommendations [are] based" and to inform investors of risks. Blavin, 760 F.2d at 712; see SEC v. Fife, 311 F.3d 1, 10 (1stt Cir. 2002).

Lucia authored the slideshows and maintained ultimate control over them. Tr. 568, 1691. Lucia also engineered the backtests. Tr. 568, 776, 791-92, 1130, 1191. In doing so, Lucia deliberately chose to present: the backtest slides and language; the historical contexts of the backtests; the misleading REIT rate of 7% for the '66 Backtest; the span of years of the backtests, which shielded the REIT investments from stock market volatility; and for the '66 Backtest, an initial investment date of 1966, five years before most REITs were available, and before any published rates were available.[34] Lucia had full control over, was fully aware of, and actually committed the violations in this case, and Lucia's scienter is imputable to RJLC.

Respondents acted with the intent to deceive. Lucia agreed that if actual inflation was used in the '66 and '73 Backtests, the portfolios would have been depleted more quickly, and would have been "damaging" to the '66 Backtest. Tr. 1150-51, 1192:9. Lucia knew that disclosing that the BOM strategy would go bankrupt would not be helpful in attracting clients. Tr. 1151-52. An encounter between Bennett and Plum also supports a finding of intent, at least as to RJLC.

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[34] Respondents argued that the '66 Backtests were created only for the benefit of Ben Stein. Tr. 772, 1137. Even if the '66 Backtest was originally created for Stein's benefit, Lucia chose to add that backtest to his slideshow. Tr. 1191.

During the 2010 examination, Bennett asked Plum about the '66 and '73 Backtests; in particular, he pointed out that use of actual inflation rates rather than an assumed inflation rate resulted in depletion of assets. Tr. 91. Plum replied that "of course, [the BOM strategy] would have gone broke, but all the portfolios would have gone broke." Id. Plum, who attended a number of seminars with Lucia, thus knew that the backtests were unrealistic and that the slideshow presented misleading results. Tr. 734-36.

Lucia offered inconsistent and contradictory testimony as to why Respondents chose 3% for an inflation rate. Lucia at one point testified that 3% was a reasonable rate because it is what is commonly used in the industry in backtests. Tr. 1147-49. He also testified that he chose 3% because the inflation rate in 1966 was 2.9% and that it was reasonable to project that the rate would stay around 3% going forward. Tr. 1325-26. It is clear, however, that Lucia was not aware that the inflation rate in 1966 was near 2.9% when he designed the backtests. He testified, "I learned yesterday, incidentally, from Dr. Grenadier that the inflation rate in 1966 was, I believe I saw on the screen, 2.9 percent." Tr. 1267. Additionally, this reasoning would not explain why Lucia chose 3% as the projection rate in his '73 Backtest. Grenadier reported that CPI-U was 6.2% in 1973 and Hekman, according to his argued reduction of 1.2% from CPI-U, opined that a reasonably adjusted inflation rate in 1973 was 5%. Div. Ex. 70, p. Appx. 2a; Resp. Ex. 35, p. Appx. 10. Furthermore, the 2.9% rate for 1966 was measured by CPI-U, which Respondents repeatedly argued is a biasedly high rate. Further contradicting his own testimony, Lucia said that he actually did use CPI-U, but used the "average of what the CPI-U has been for the past hundred years." Tr. 1289; 1328-29.

Respondents were aware of the impact of fees on any investment and deliberately chose not to include fees or disclose that the totals at the end of the backtests were not net of fees, demonstrating an intent to keep attendees in the dark. During cross-examination, Lucia agreed that a managed portfolio that charges a fee and that produces the identical return of a non-managed portfolio would produce significantly less over a thirty to forty-year period. Tr. 1203. Lucia also testified that he could not have included fees in his backtests because they included products that RJLC did not manage. Tr. 1284. Specifically, he said, "if I show it charging a fee, I'm in trouble." Tr. 1284. That testimony is contradicted by the self-bucketing example that he provides during his slideshows and the relevant discussion in the Webinar. During the Webinar, he states, regarding a portfolio of hypothetical low-risk investment interests: "And if it lost two percent per year – let's say it grew at six percent in some diversified portfolio, but after fees, it only netted four percent, and you took out six, that's a minus two." Resp. Ex. 30; Div. Ex. 66, p. 62. Similarly, Lucia was willing to include estimates of a fee in his discussion of how they would drain a typical mutual fund portfolio. Resp. Ex. 30; Div. Ex. 66, p. 24. It is clear Lucia was willing to discuss hypothetical fees when it suited his message. His suggestion otherwise demonstrates an intent to purposefully exclude the fees to strengthen the returns of the backtests.

Respondents admitted that they deliberately chose not to rebucketize the backtests and to leave the entire balance in the stock market, and admitted they did not explicitly disclose either fact. Tr. 859, 1130, 1188-89. Their supposed reasoning for leaving the balance in stocks for the majority of the backtests'

lifespan was to ensure that they did not "cherry pick" the time to rebalance. Tr. 859, 1323, 1327. This is not plausible. Respondents acknowledged that they advocate against being invested completely in the stock market, but Lucia knew that the stock market produced above-average returns during the years that the backtest portfolios were allocated entirely to stocks. Tr. 536, 729-30, 1130, 1145. By structuring the backtest the way that they did, they took advantage of a higher-producing strategy, essentially engaging in cherry picking, than if they had rebucketized, the way attendees would have expected. The decision not to rebucketize, knowing (with hindsight) that the stock market produced impressive returns during the relevant period, demonstrates an intent to mislead.

Lucia discussed how Ben Stein was skeptical of the BOM strategy. Div. Ex. 66, p. 47. Lucia, however, satisfied Stein with what he asserted was a backtest. He stated: "Well, I did a backtest for Ben [Stein]." Id.; Tr. 1318. Lucia was clearly not telling Stein that he created a true hypothetical like with his fictional investors; rather he was claiming to use an actual backtest to prove that BOM worked, and he then did the same with seminar attendees. Similarly, he touted the BOM strategy as a "time-tested" one based upon "empirical evidence" and "science, not art." Div. Exs. 10, 16; Tr. 624-25, 1050, 1111. Lucia knew that the BOM strategy had not been backtested, as seminar attendees would have understood that term, as opposed to how the "financial industry" allegedly would have understood the term. This is demonstrated by the fact that what are called backtests in the slideshow do not qualify as either backtests or hypotheticals even under Lucia's definition. Lucia testified that a backtest is "forward-looking," even though

at least the '66 Backtest was a mix of historical and assumed data. Tr. 1127.

The misstatements on the "Back Tested Buckets" slide, although not charged in the OIP, also demonstrate an intent to deceive. Div. Ex. 1, p. 467. Plum's testimony and demeanor when questioned about the claimed use of treasury returns and S&P 500 returns suggest that he was, initially, sincerely confused about that slide. Lucia, by contrast, testified that he knew that the stock returns were not completely accurate and said nothing about the accuracy of the bond retrurns, and further testified that the inaccuracy was only discovered "within the last couple weeks." Tr. 1078-80. I find Lucia's testimony about the alleged discovery of the misstatements to be knowingly false. First, if he had truly discovered the problem weeks before his testimony, there is no reason he would not have told Plum, but Plum clearly knew nothing about it at the hearing. Second, it is utterly implausible that Lucia, who determined the contents of the slideshow and gave every seminar (in contrast to Plum, who did not attend them all), and has given them hundreds of times, would not be aware of the false information contained in the "Back Tested Buckets" slide. I conclude that Lucia knew of the misstatements and kept them in the slide to deceive prospective customers.

In some instances, Respondents acted recklessly. Lucia departed from the standards of care by not ensuring the accuracy of the information on which his recommendations were based, and this departure was extreme. The backtests were not supported by the spreadsheets or any other documentation, and Lucia testified that he did not think he was required to maintain such documentation. Allegedly, some

backtest calculations were generated by a junior analyst who was a recent college graduate and who apparently got his job because he was dating Lucia's daughter. Lucia's employees, particularly Ochs, apparently thought that the backtests were properly documented, because they produced documents that they believed constituted support for them, but were not, in fact, support. The inaccuracies discovered in the slideshow demonstrate that Lucia placed little emphasis on accuracy in the calculations he so enthusiastically presented to prospective investors. He also had no mechanism in place to correct inaccuracies. Tr. 667-68. Respondents contested the findings of the 2010 examination, and posted a video refutation of the OIP, before conducting the internal investigation which supposedly revealed errors in the '73 Backtest slides and the first spreadsheet. Tr. 1205-08. Lucia told Dr. Hekman that a mathematical error had been identified in the "Back Tested Buckets" slide. Tr. 1537-38; Div. Ex. 1, p. 467. However, Lucia testified disingenuously, as if he did not know of the error. Tr. 1080-81. It was not reasonably prudent, and it was an extreme departure from the standards of ordinary care, for the extensive number-crunching required to support the crucial parts of the slideshow, including the claims regarding the '66 and '73 Backtests, to be undocumented and irreproducible even by Respondents' own expert witness.

Lucia also departed from the standards of care in an extreme way by failing to inform seminar attendees of the risks of investing in REITs. Lucia failed to put in disclaimers in the '66 Backtest slides, from which a reasonable investor would have understood that the '66 Backtest slides were less "hypothetical" than the preceding slides. Div. Ex. 1, pp. 471-78. Although not so much a risk as an extremely material

fact, he also failed to inform seminar attendees that REITs were essentially unavailable prior to 1972, and that the spreadsheet allegedly supportive of the '66 Backtest assumed an investment in REITs spanning a bear market in stocks.

Given Lucia's extensive experience promoting REITs and long career as an investment adviser, and the large revenues he earned by selling them, he must have known that they were illiquid and essentially unavailable until 1971. Lucia nonetheless presented REITs, falsely and misleadingly, as if they were liquid and purchasable in 1966. When discussing the BOM strategy in detail during the Webinar, Lucia states "in the sixties, you could have got about $15,000 per year income, dividends from that real estate investment." Div. Ex. 66, p. 44:22-25. In the slideshow, REITs are allegedly backtested to 1966, and according to the spreadsheet, they are liquidated, conveniently, exactly when they are needed to refill the "safe" bucket. Div. Ex. 1, p. 478; Div. Ex. 12.

Respondents had a motive to misrepresent the facts about REITs: their non-traded REIT revenues were so significant to their bottom line that they had an overwhelming incentive to promote them. Lucia asserts now, and testified, that the BOM strategy is purely a "withdrawal" strategy, and is not an asset allocation strategy. Lucia's assertion is knowingly false. The backtest discussion in the slideshow is not merely a discussion of a withdrawal strategy, it is transparently a discussion of the benefits of investing in REITs, with the intent to lure prospective investors into buying them.

a. Lack of Investor Complaints

Respondents dispute the claim that they knew that the information they provided was misleading because, they argue, no audience members ever complained that such information was misleading. Resp. Br., p. 52-54. I do not find this argument convincing. It is not the responsibility of investors or prospective investors to make a respondent aware that something is misleading, it is the responsibility of advisors to act as their clients' and prospective clients' fiduciaries. Respondents cite no law in support of their argument, and indeed, Section 206 of the Advisers Act focuses upon the investment adviser and his or her actions. Clients and prospective clients are mentioned only in relation to the advisors. See SEC v. Gruss, 859 F. Supp. 2d 653, 662-63 (S.D.N.Y. 2012).

b. Reliance on Compliance Network and the Commission

Respondents argue that they could not have acted with scienter because multiple layers of internal and external compliance review vetted the materials, and none of them informed Lucia that the backtests were misleading. Resp. Br., p. 4, 54-56; Tr. 1607. In addition to its own compliance networks, Respondents argue that OCIE reviewed similar materials, including an earlier version of the slideshow, in 2003, and found no fault with it, essentially sanctioning the content. Resp. Br., p. 56. Respondents cite to SEC v. Slocum, Gordon & Co., 334 F. Supp. 2d 144 (D.R.I. 2004), in which the court found that the defendant relied upon independent external auditors and the Commission, neither of which raised issue with the defendant's account structure. I do not find merit in these arguments.

Respondents point to reviews by its network affiliated broker-dealers, first, Securities America, and second, First Allied, both of which cleared the slides, as wholesale endorsement of the backtests. Resp. Br., p. 54-55. These affiliates were not independent auditors, however. Both affiliates had joint venture agreements with Lucia and RJLC and drew substantial revenues from them. Tr. 445-46, 450. The affiliates, knowing the volume of leads generated by Lucia, which turned into revenue for them, could not be relied upon as true independent arbiters of the slideshow content. In 2003, while Ochs was with Securities America and reviewing Lucia's marketing material, she and her colleagues specifically requested that Lucia disclose the basis for the REIT return rates he used. Tr. 565; Resp. Ex. 20. There is no evidence that Lucia ever added those bases, and they do not appear anywhere in the slideshow. Div. Ex. 1. The '66 Backtest slides, unlike virtually every other section of the slideshow, bear no disclaimers at all, suggesting that there was in fact no advertising review of them. Div. Ex. 1, pp. 469-78. Furthermore, there is no evidence that anyone provided any support for the backtests to either affiliate, so that either would have a chance to consider the validity of the backtest slide figures.[35]

Respondents also cite to RJLC's internal compliance office to buttress the claim that the backtests were reasonable and in accordance with industry

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[35] In addition to ignoring compliance advice from its future chief compliance officer on the disclosure of the bases for REIT rates of return, one reason RJLC ended its relationship with Securities America was an unfavorable audit by Securities America, at least one of the subjects of which was the BOM strategy. Tr. 454-60.

standards. Resp. Br., p. 32. Ochs, RJLC's Chief Compliance Officer, seriously undermined that argument. Ochs, who was in charge of the office tasked with reviewing the slideshows, testified that she understood a backtest to be in accordance with the definition provided by the Division and its expert. Tr. 574-75. Thus, the head of Lucia's compliance department did not understand that Lucia's claimed "backtests" were not proper backtests. She could not have concurred that the slides were not misleading if she did not even understand the material. Additionally, Ochs came from Securities America were she had been part of a compliance team tasked with reviewing Lucia's marketing materials, including the slideshows. Tr. 445. Thus, two of the three levels of compliance review involved a common denominator in Ochs, who understood the term backtest to mean something different from what Lucia now offers. Tr. 575. Accordingly, little significance can be assigned to the compliance reviews.

Respondents' argument that the 2003 Commission review concluded that the "'73 Illustration slides did not violate securities laws" is unpersuasive. The Respondents point to no evidence that the Commission review made any such conclusion. The 2003 examination report stated only that RJLC did not advertise performance. Resp. Br., p. 19-20; Resp. Ex. 22, p. 3. That is a far cry from concluding the '73 Backtest did not violate securities laws. Moreover, it is not clear that the 2003 examiners asked for documentation of the backtest slide figures, which then comprised only the '73 Backtest, or that the examiners knew in 2003 that the slides were unsupported by any documentation, or that they examined any aspect of Respondents' REIT-connected activities. Resp. Ex.

22. It was only after Respondents produced a spreadsheet to OCIE in 2010, purportedly supporting the '73 Backtests, that OCIE knew how misleading the claims were. It was not reasonable for Respondents to assume, as they claim they did, that because the 2003 examination raised no issues regarding the '73 Backtest slides that the slides were not misleading. As noted, the '73 Backtest slides contained knowingly false statements regarding the assumptions behind the '73 Backtest; even if some of those assumptions were not charged as misrepresentations in this proceeding, Respondents could not possibly have believed that the '73 Backtest slides were not misleading. Even if the 2003 examination report (as opposed to the associated deficiency letter) had made such a conclusion, Respondents could not have relied upon it because they only received the examination report as part of discovery in this matter. Div. Reply, p. 52. Most significantly, the 2003 examination reviewed a version of the slideshow presentation that included only the '73 Backtest slides. Tr. 1484; Div. Ex. 21. That slideshow did not include the red flag-raising claim that the addition of REITs to a non-REIT BOM portfolio triples a portfolio's value, as the '66 Backtest does. Div. Ex. 21.

Slocum, where partial reliance on Commission examinations negated scienter, is inapplicable here. In Slocum, the defendants brought specific issues regarding account structure, which was later a basis of alleged fraud, to the Commission's attention during two examinations. 334 F. Supp. 2d at 160-61. Further, the defendants in Slocum relied upon the advice of counsel to structure its accounts, and after Commission and independent auditor recommendations regarding the specific account structures, tried to remedy them in accordance with those recommendations.

Id. at 159-60. Here, the 2003 examination did not focus upon the backtest issue, the issue was not specifically brought to the examiners' attention, and there is no evidence of reliance on advice of counsel.

4. Materiality

The Division proved that Lucia and RJLC's misrepresentations were material. The standard of materiality under Section 206 is whether or not a reasonable investor would have considered the information important in deciding whether or not to invest. See Basic, Inc. v. Levinson, 485 U.S. 224; 231-32, 240 (1988); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Materiality is proved by showing a 'substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.'" SEC v. Ginsburg, 362 F.3d 1292, 1302 (11th Cir. 2004) (quoting TSC Indus., 426 U.S. at 449 (1976)). Materiality does not require proof that accurate disclosure would have caused the reasonable investor to change his decision, but only that the omitted fact would have assumed actual significance in the deliberations of the reasonable investor. TSC Indus., 426 U.S. at 449.

A reasonable investor would consider the REIT investments in the backtests as dispositive proof that BOM with REITs was a wise investment choice. The contrasts between the fictional investor's "balanced" portfolio against the BOM portfolio with REITs, and the '66 Backtest without REITs against the '66 Backtest with REITs, could not have more clearly made the case for REITs. In the '73 Backtest, in contrast to the fictional investors without REITs, the fictional investors using BOM with REITs maintained a more than $1.5 million investment. According to the

'66 Backtest, a BOM portfolio without REITs would maintain a balance of $1.2 million after thirty-eight years while a BOM portfolio with REITs would be worth $4.7 million, more than triple the amount. Indeed, RJLC clients Richard DeSipio and Dennis Chisholm both testified that the discussion of REITs in their seminars was important in deciding to purchase non-traded REITs through RJLC. Tr. 281, 283, 380.

The use of an inflation rate much lower than historical rates, without disclosure that using historical rates would bankrupt the backtest portfolios, is plainly material. As demonstrated in Hekman's analysis, even a reduced inflation rate would cause the '66 Backtest to go bankrupt after 1993, ten years prior to the end of the backtest presented by Respondents, which, as presented, produced remarkable returns through 2003. Investors would surely not be interested in engaging RJLC as an adviser if they were told that the backtested portfolios went bankrupt after twenty or even twenty-eight years, especially because BOM was trumpeted as one that withstood the effects of inflation. Because Respondents' assumed stock returns differed between the Bold Bucketeers and the '73 Backtest, the '73 Backtest was not a demonstration that withdrawing safe money first is better regardless of the inflation rate; as noted, Respondents compared apples to oranges on this point, and in any event no documentary evidence of such a demonstration has surfaced. See Tr. 800. Inasmuch as the '73 Backtest was presented as such a demonstration during the seminars, it was materially misleading on that basis, as well.

In general, it is materially misleading to fail to disclose that advisory fees have not been deducted.

See F.X.C. Investors Corp., Initial Decision Release No. 218 (Dec. 9, 2002), 79 SEC Docket 472, 485. As noted, Respondents concede that advisory fees materially affect a portfolio's returns. Tr. 1199, 1203, 1285. Grenadier's expert report demonstrates the impact that inclusion of modest fees would have had upon the backtests. For example, modest fees on an index-tracking stock portfolio included in the '66 Backtest would have nearly halved the $4.7 million outcome to $2.5 million. Div. Ex. 70, pp. 15-16, Ex. 6a. Using similar fees would have quartered the final balance in the spreadsheet for the 1973 calculations. Id., Ex. 6b. Chisholm and DeSipio both testified that learning that the backtests failed to include fees would have been an important fact in their investment decisions. Tr. 289, 375-76.

It was material to fail to disclose that the backtested portfolios were not rebucketized or that they ended up being invested completely in stocks. Seminar attendees were led to believe that BOM would always maintain a safe income bucket to spend from before drawing from riskier investments. They were, further, advised against ever investing entirely in stocks. Attendees would, therefore, have wanted to know that the backtests supposedly proving the science behind BOM did not follow these basic principles, and that the positive results were largely attributable to fortunate timing of the stock market. Chisholm made clear that he would have found it important to know the facts about the bucket allocation following the first fourteen years of the backtests. Tr. 375.

a. Investment Decision

Lucia argues that SEC v. Goble, 682 F.3d 934 (11th Cir. 2012), precludes this action because RJLC's misrepresentations were not material. The court held

in Goble that misrepresentations influencing investors' choice of broker-dealer were not material because they did not encompass an investment decision. Id., at 944. In Goble, the defendant brokerage firm had misrepresented the level of its diminished capital reserves. The Commission's rationale for charging the defendant pursuant to Exchange Act Section 10(b) was that an investor client would consider it material whether its broker was solvent. Id. The court stated that such a rationale "cannot form the basis for [Section] 10(b) securities fraud liability." Id.

Lucia argues that, as in Goble, any misrepresentations would only influence a seminar attendee's decision to choose RJLC as an investment adviser, not to make a specific investment decision. To be sure, there is no evidence that RJLC or Lucia tried to sell specific securities at the seminars, nor are there any allegations by the Division that they did. But even assuming that the only basis for Lucia's violations of Sections 206(1) and 206(2) was that seminar attendees were influenced to choose RJLC as their investment adviser, Goble would not preclude liability. Advisers Act Section 206(1) and 206(2) do not share the requirement of Exchange Act Section 10(b) that misrepresentations occur "in connection with the purchase or sale of any security." Compare 15 U.S.C. § 78j(b) (Exchange Act Section 10(b)) with 15 U.S.C. § 80b-6 (Advisers Act Section 206). Though the basic test for materiality under the two statutes is similar, "[t]he elements for liability under . . . Section 10(b) and Rule 10b-5 of the Exchange Act . . . are more stringent than the requirements to violate Sections 206(1) and (2) of the Advisers Act." SEC v. Lauer, 2008 WL 4372896, at *24 (S.D. Fla. Sept. 24, 2008). "Congress intended the [Advisers Act] to be construed like other

securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes." SEC v. Capital Gains Bureau, Inc., 375 U.S. 180, 195 (1963).

It is well established that investment advisers may be held liable under the Advisers Act even without misrepresentations specific to a client investment decision. See, e.g., Vernazza, 327 F.3d at 859 (investment adviser's false representations of conflicts of interest in its Form ADV filed with the Commission was material); SEC v. K.W. Brown & Co., 555 F. Supp. 2d 1275, 1308 (S.D. Fla. December 19, 2007) (investment adviser's scheme extending gains in favor of preferred clients while passing along losses to other clients was material because it was determinative as to whether clients would invest their money and trust with the defendant)[36]; SEC v. Moran, 922 F. Supp. 867, 896 (S.D.N.Y. 1996) (defendant investment adviser's insider trading scheme allocated higher-priced shares to client accounts than its own, to the detriment of firm clients). Accordingly, Goble does not bar liability here.

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[36] K.W. Brown cited to Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987), 39 SEC Docket 653, an interpretive release by the Commission, which stated that "the Commission has applied Sections 206(1) and 206(2) in circumstances in which the fraudulent conduct arose out of the investment advisory relationship between an investment adviser and its clients, even though the conduct does not involve a securities transaction." Id., at 670-71.

b. Omission of Material Fact

Respondents never warned that REIT rates, for example, were hypothetical and not historically accurate, a material omission of fact. Respondents cite to disclaimer language used throughout the slideshows and invoked by Lucia in his narration as evidence that audience members could not have been misled, and that they would understand that the rates used for the backtests were entirely hypothetical. Resp. Br., p. 2 n.2. As noted supra, though, the slideshow's assertions regarding REITs were misleading in multiple ways, including that they suggested that REITs were reasonably available as investments as far back as "the sixties." Div. Ex. 66, p. 44. A reasonable investor would have wanted to know that REITs were not available at that time, and that REIT returns were not merely "hypothetical," as the slideshow states, but effectively nonexistent. Additionally, the most frequently used disclaimer throughout the slideshow, including during the backtests, was that the slideshow was representing hypothetical investments and that past performance was not indicative of future returns. Div. Ex. 1; Tr. 227, 567. The proceeding does not allege that Lucia used actual examples, or that by using the backtests, he was guaranteeing future returns, which is what the disclaimers warned. Even if the disclaimers had been more direct, general cautionary language does not render omission of a specific misleading historical fact immaterial. See SEC v. Merchant Capital, LLC, 483 F.3d 747, 768 (11th Cir. 2007) (citing In re Westinghouse Sec. Litig., 90 F.3d 696, 710 (3d Cir. 1996)); Klein v. First Western Gov't Securities, Inc., 24 F.3d 480, 489 (3d Cir. 1994).

B. Section 206(4) of the Advisers Act

Section 206(4) of the Advisers Act prohibits engaging in "any act, practice, or course of business that is fraudulent, deceptive, or manipulative," and authorizes the Commission to prescribe rules designed to prevent such conduct. 15 U.S.C. § 80b-6(4). As with Section 206(2), which prohibits engaging in "any transaction, practice, or course of business which operates as a fraud or deceit," scienter need not be proven under Section 206(4). 15 U.S.C. § 80b-6(2); Capital Gains Research Bureau, 375 U.S. at 195.

Just as Respondents' misrepresentations constituted a practice or course of business which operated as a fraud or deceit under Section 206(2), they also constituted a practice or course of business that was fraudulent and deceptive under Section 206(4). Accordingly, Respondents violated Section 206(4).[37]

Rule 206(4)-1(a)(5) makes it a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) for a registered investment adviser to publish, circulate, or distribute any advertisement "[w]hich contains any untrue statement of a material fact, or which is otherwise false or misleading." 17 C.F.R. § 275.206(4)-1(a)(5). Conduct under this Rule must be measured from the viewpoint of a person unskilled and unsophisticated in investment matters. See SEC v. C.R. Richmond & Co., 565 F.2d 1101, 1104-05 (9th Cir.

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[37] Violation of one of its associated Rules is not a precondition to finding a violation of Section 206(4). See Warwick Capital Mgmt., Inc., Advisers Act Release No. 2694 (Jan. 16, 2008), 92 SEC Docket 1410, 1411 n.3 (finding a violation of Section 206(4) without an associated violation of Rule 206(4)-1(a)(5)).

1977). Scienter is not an element. See Capital Gains Research Bureau, 375 U.S. at 195.

The Division alleges that the backtests constituted misleading performance advertising, a sub-category of prohibited Rule 206(4)-1(a)(5) advertisements. I find that Respondents' seminar presentations do not qualify as advertising, and are therefore not performance advertising. Rule 206(4)-1(b) defines what specific types of advertisements are included under Rule 206(4)-1(a). The term "advertisement" includes "written communication[s] addressed to more than one person . . . or any notice or other announcement in any publication or by radio or television." 17 C.F.R. § 275.206(4)-1(b). The concept of advertisement has been construed liberally, and includes "investment advisory material which promotes advisory services for the purpose of inducing potential clients to subscribe to those services." C.R. Richmond, 565 F.2d at 1105.

Lucia disseminated his misrepresentations in his books and through his radio and television shows, as well as via seminars and at least one webinar. Tr. 1025-26; Div. Exs. 66-69. At the seminars, various printed materials were distributed, but they do not appear to have been summaries of the BOM strategy. Tr. 1052-55. The OIP asserts that Lucia promoted the BOM strategy on "his radio show and website, at seminars, and in his books." OIP, pp. 2-4. Nonetheless, the core allegation of the OIP is that "it was materially misleading for Respondents to claim that their alleged backtesting validated the BOM strategy," after which the OIP almost exclusively discusses the slideshow. OIP, pp. 7-9.

Consequently, there is some doubt about whether the OIP provides fair notice to Respondents that they

stand accused of violating Rule 206(4)-1(a)(5) by misrepresentations other than those made at the seminars. In view of the limited scope of the Division's argument in its post-hearing brief on this point – only that "Respondents' seminar slideshow is an advertisement within the meaning of the Rule" – I conclude that only misrepresentations at the seminars may be found violative of Rule 206(4)-1(a)(5). Div. Br., p. 40.

Given this limitation, the Division has not proven that "written communications" include live slideshow presentations. The precedent, outdated as it may be, holds written communications to include only traditional media, including books, newsletters, and newspaper and magazine advertisements. See, e.g., SEC v. Suter, No. 81-3865, 1983 WL 1287, *12 (N.D. Ill. Feb. 11, 1983) (newsletters); SEC v. Lindsey-Holman Co., No. 78-54-MAC, 1978 WL 1129 (M.D. Ga. Aug. 6, 1978) (newspaper advertisements); C.R. Richmond, 565 F.2d at 1104 (books and newsletters). There is no evidence that slideshow printouts or synopses thereof were handed out to seminar participants or otherwise published in printed or handwritten form at the seminars. I do not find that the slideshow presentations were "written communications" as that term has been interpreted. Accordingly, Respondents did not violate Rule 206(4)-1(a)(5).

C. Section 204 of the Advisers Act

Advisers Act Section 204 requires investment advisers to "make and keep for prescribed periods such records . . . as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 80b-4(a). Advisers Act Rule 204-2(a)(16) requires investment advisers to keep true and accurate record of:

> All accounts, books, internal working papers, and any other records or documents that are necessary to form the basis for or demonstrate the calculation of the performance or rate of return of any or all managed accounts or securities recommendations in any notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication that the investment adviser circulates or distributes, directly or indirectly, to 10 or more persons (other than persons connected with such investment adviser); provided, however, that, with respect to the performance of managed accounts, the retention of all account statements, if they reflect all debits, credits, and other transactions in a client's account for the period of the statement, and all worksheets necessary to demonstrate the calculation of the performance or rate of return of all managed accounts shall be deemed to satisfy the requirements of this paragraph.

17 C.F.R. § 275.204-2(a)(16). The plain language of the Rule encompasses only advertisements of performance or rates of return for managed accounts or specific securities recommendations. Though Lucia's seminars influenced individuals to purchase classes of securities from RJLC, particularly non-traded REITS, Lucia never advertised a specific security, nor is there evidence that the examples used in the slideshow were specific managed accounts. The same is true of the Webinar. Div. Br., p. 44 n.12. Accordingly, Lucia was not required to maintain the above-referenced

records, and did not violate either Section 204 or Rule 204-2(a)(16) thereunder.[38]

D. Aiding and Abetting

Lucia willfully aided and abetted RJLC's violations of Sections 206(1), 206(4), and 206(2) of the Advisers Act. To establish a claim of aiding and abetting there must be: (1) a primary violation of the securities laws; (2) knowledge of the primary violation by the aider and abettor; and (3) substantial assistance by the aider and abettor in the commission of the primary violation. SEC v. DiBella, 587 F.3d 553, 566 (2d Cir. 2009). Lucia acted with scienter, and provided much more than substantial assistance. He was not only the controlling sole shareholder of RJLC, but he was the creator of the slideshow, the seminar marketing, the backtests, and all of the components to the backtest, including the REIT rates, the length and timing of the REIT investments, and the historical periods to use as context. The finding that RJLC violated Sections 206(1), 206(2), and 206(4) of the Advisers Act inescapably leads to a finding that Lucia aided and abetted it.

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[38] In contrast to Section 206(4), the language of Section 204 suggests that it may only be violated if one of its associated Rules is violated. 15 U.S.C. § 80b-4(a) ("as the Commission, by rule, may prescribe" (emphasis added)). In any event, the Division makes no argument regarding Section 204 separate from its argument regarding Rule 204-2(a)(16). Div. Br., pp. 43-44. I therefore find no separate violation of Section 204. Additionally, not being required to comply with this particular Rule is not mutually exclusive with Respondents' violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act. That Respondents failed to properly maintain records is relevant at least to evaluating scienter and determining whether their statements were misleading, even though their failure was not a technical violation of the Rule.

E. Affirmative Defenses

1. Statute of Limitations

Respondents included as an affirmative defense that this proceeding is barred by the five-year statute of limitations for fraud claims, codified at 28 U.S.C. § 2462, because the violations were discovered, or should have been discovered, during the Commission's review in 2003. Lucia Answer, p. 8; RJLC Answer, p. 8; Resp. Br., p. 69. Under Gabelli v. SEC, 133 S.Ct. 1216, 1220-21 (2013), the statute of limitations clock begins running at time of accrual, that is, when the cause of action becomes enforceable. Each presentation of the misleading slideshow was a separate and distinct violation, and any resulting cause of action could not have accrued until the presentation occurred. See David Henry Disraeli, Exchange Act Release No. 57027 (Dec. 21, 2007), 92 SEC Docket 852, 875 (multiple material misrepresentations and omissions constituted "repeated violations"); Warwick Capital Mgmt., Inc., 92 SEC Docket at 1427 ("repeated instances of egregious . . . behavior" violative of Sections 206(1), 206(2), and 206(4)). The limitations clock thus runs from each violative presentation, not from the date of the first violative presentation.

In any event, the statute of limitations does not apply to this entire proceeding, but only to particular sanctions, specifically, civil penalties and any associational bar. See Gregory O. Trautman, Exchange Act Release No. 61167 (Dec. 15, 2009), 97 SEC Docket 23492, 23525-26.[39] The OIP makes no allegations regarding the time period, so it is important to consider

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[39] An amended version of this Commission Opinion is available only on the Commission's website. In pertinent part, it is materially identical to the printed Release.

when these acts occurred in evaluating those sanctions. As the record shows, Lucia has been giving some semblance of the BOM slideshow presentation since 2000, and was presenting the backtest slides as late as December 2010, when Respondents received OCIE's deficiency letter. Because each presentation was a new unlawful act, the clock began running anew each time Lucia presented the slideshow. The OIP was filed on September 5, 2012, and thus, seminars occurring any time after September 5, 2007, five years prior, can be considered in this proceeding as to those issues affected by the statute of limitations.

2. Due Process

Respondents present two due process arguments: (1) that their rights were violated because the formal order of investigation (FOI) was approved while the OCIE examination was ongoing, and (2) that they lacked fair notice that their conduct was proscribed. Resp. Br., pp. 22-25, 66-69. It is not clear whether I have the authority to even entertain such due process claims. See Gregory M. Dearlove, CPA, Exchange Act Release No. 57244 (Jan. 31, 2008), 92 SEC Docket 1867, 1920-21, 1926 (resolving the claim that the Commission's Rules of Practice violated due process, an issue that the ALJ had declined to address as a matter better left to the Commission), pet. denied, 573 F.3d 801 (D.C. Cir. 2009). Assuming that I do have such authority, I conclude that Respondents' due process arguments lack merit.

First, Respondents argue that the investigation in this matter violated their due process rights because the FOI was approved on December 2, 2010, fifteen days before the December 17, 2010 deficiency letter issued, but Respondents did not learn of the FOI until May 11, 2011. Resp. Br., p. 24. However, due process

does not require notice, either actual or constructive, of an administrative investigation into possible violations of the securities laws. RNR Enters., Inc. v. SEC, 122 F.3d 93, 98 (2d Cir. 1997) (quoting Gold v. SEC, 48 F.3d 987, 991 (7th Cir. 1995)). The timing of the FOI may have been unusual or irregular, but neither party has pointed to any authority addressing that issue. Certainly, Rule 7(a) of the Commission's Rules Relating to Investigations, which by its own terms applies only to formal investigative proceedings, as opposed to examinations, does not require the Division to inform a party of its investigation merely because OCIE is simultaneously conducting a lawful examination of that party. See 17 C.F.R. § 203.7(a). Moreover, Respondents have shown no prejudice arising from the timing of the FOI. The evidence is uncontroverted that the Division did not use OCIE's examination as a "stalking horse" to obtain evidence outside the normal investigative process. Tr. 214. Respondents had a choice: respond to the deficiency letter or not. This choice would have been the same whether or not they had been aware of the investigation, and whatever response they made would have been just as accessible to the Division regardless of when the FOI issued. Respondents, as registered investment advisers, were required by law to cooperate with OCIE and provide documentation as needed. See 15 U.S.C. § 80b-4(a). It seems unlikely that, even if provided with the FOI, Respondents would have chosen to stop cooperating with OCIE, nor have they identified any particular thing that they would have done differently in that situation.

Second, Respondents cannot "credibly claim lack of fair notice of the proscription against defrauding investors." Valicenti Advisory Servs., Inc. v. SEC, 198 F.3d 62, 66 (2d Cir. 1999). Respondents nevertheless

offer four arguments in support of their contention that they lacked reasonable notice that their conduct was unlawful, none of which I find persuasive. Resp. Br., pp. 66-69. First, as discussed above in connection with Rule 204-2(a)(16), the slideshows did not constitute performance advertising, so any vagueness about the law of performance advertising is irrelevant. Second, even assuming that the slideshows "comport with industry standards" in part, they are also materially misleading, which is obviously not an industry standard. Id., p. 68. Third, the OIP alleges that "it was materially misleading for Respondents to claim that their alleged backtesting validated the BOM strategy," that is, Respondents are charged with making materially misleading factual assertions and omissions, including as to a particular security, non-traded REITs. OIP, p. 7. Respondents' assertion that they have been "prosecuted . . . for hypothetical illustrations which are a comparison of withdrawal strategies unrelated to any managed account or security," is simply false. Resp. Br., p. 68. Fourth, the 2003 slideshow devotes at most five slides to the 1973 backtest, has no discussion of backtesting to 1966, and does not compare REIT and non-REIT investment. Div. Ex. 21, pp. 74-76. The 2009-10 slideshow, by contrast, devotes thirteen slides to the backtests, discusses backtesting to 1966, and shows the alleged advantages of investing in REITs by comparing investments with and without them. Div. Ex. 1, pp. 466-78. The 2003 slideshow did not possess "identical issues to those in the OIP," and the OIP does not constitute a "change of course." Resp. Br., p. 68.

3. Other Defenses

Respondents' Answers originally included eight affirmative defenses, but the defenses of waiver and

unclean hands were stricken by Order on November 7, 2012. Except for the seventh affirmative defense, addressed infra, Respondents apparently found insufficient merit in the remaining affirmative defenses to justify addressing them in their post-hearing brief or reply. I, too, find insufficient merit in them to warrant discussion.

V. SANCTIONS

The Division requests that Lucia be barred from association with any investment adviser and broker-dealer, that Lucia and RJLC have their investment adviser registrations revoked, that they be ordered to cease and desist from further violations of the securities laws, and that they be required to pay civil money penalties of $150,000 and $725,000, respectively. Div. Br., pp. 46-47. The Division also requests that Lucia be required to "disclose at any future seminars that he has been sanctioned for providing misleading performance data about the BOM portfolio strategy." Id., p. 47.

The sanctions listed below are unchanged from the July 8, 2013, Initial Decision, in which I stated that even if there were violations resulting from the misrepresentations the OIP charged that I did not address, the sanction would remain the same. I had already ordered the severest sanctions available for the requested collateral bar and registration revocation, and I issued a cease-and-desist order. In view of Respondents' additional proven misrepresentations, I see no reason to change those sanctions. The only other different sanction available is in the civil penalty amount. Although the egregiousness of Respondents' conduct is greater in light of the additional proven misrepresentations, I continue to find that the mitigating factors weigh in favor of civil penalties of

approximately one third of the maximum. I therefore reconfirm the penalty amounts in the July 8, 2013, Initial Decision.

A. Willful Violations and the Public Interest

The Division seeks sanctions pursuant to Section 15(b) of the Exchange Act and Sections 203(e), 203(f), 203(i), and 203(k) of the Advisers Act. OIP, p. 10; Div. Br., pp. 44-47. To impose sanctions under some of these sections, Respondent's violations must be willful. 15 U.S.C. § 78o(b)(6)(A)(i); 15 U.S.C. §§ 80b-3(e), (f), & (i) (2010); see also Rapoport v. SEC, 682 F.3d 98, 108 (D.C. Cir. 2012). A finding of willfulness does not require intent to violate the law, but merely intent to do the act which constitutes a violation of the law. Wonsover v. SEC, 205 F.3d 408, 414 (D.C. Cir. 2000); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976).

Lucia and RJLC acted willfully. Lucia's statements were not the result of a mistake or clerical error, they were made voluntarily and knowingly. See Wonsover, 205 F.3d at 413-15. As Lucia testified, he worked on the backtests and authored the slideshows. Tr. 1066-67, 1089, 1095. Therefore, Lucia acted willfully, and as its controlling person, his willfulness is imputed to RJLC.

When considering whether an administrative sanction serves the public interest, the Commission considers the factors identified in Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979), aff'd on other grounds, 450 U.S. 91 (1981): the egregiousness of the respondent's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the

wrongful nature of his or her conduct, and the likelihood that the respondent's occupation will present opportunities for future violations (Steadman factors). Gary M. Kornman, Advisers Act Release No. 2840 (Feb. 13, 2009), 95 SEC Docket 14246, 14255, pet. denied, 592 F.3d 173 (D.C. Cir. 2010). The Commission also considers the extent to which the sanction will have a deterrent effect. See Schield Mgmt. Co., Exchange Act Release No. 53201 (Jan. 31, 2006), 87 SEC Docket 848, 862 & n.46 (citations omitted). The Commission's inquiry into the appropriate sanction to protect the public interest is a flexible one, and no one factor is dispositive. See Gary M. Kornman, 95 SEC Docket at 14255.

In this case the public interest factors weigh in favor of a heavy sanction. Lucia has over thirty-eight years of experience as an investment adviser. He knew his fiduciary obligations as an investment adviser and he knew that he was violating them by misleading prospective clients. He and RJLC became very financially successful as a result. He committed these violations many times between 2007 and 2010. Thus, Respondents' violative behavior was egregious, recurrent, and performed with scienter. Respondents have utterly failed to recognize the wrongful nature of their conduct. Lucia's current occupation as an investment adviser and media presence, and RJLC's registration, provide immediate opportunities to repeat the violations.

To his credit, Lucia has made efforts to end the violative conduct. However, following the 2003 deficiency letter, RJLC informed the Commission, in writing, that it would cease using misleading figures regarding the longevity of the firm, the number of clients serviced, and the amount of assets managed.

Resp. Ex. 14. Despite those assurances, RJLC continued using those figures until OCIE discovered them and noted them in the 2010 deficiency letter. Div. Ex. 2. This is probably because they did not consider the figures misleading. Resp. Ex. 7. Respondents' inability to keep their promises to OCIE undercuts the credibility of similar assurances going forward. Admittedly, Respondents stopped using the backtest slides and recalled Lucia's books after OCIE's 2010 deficiency letter. Tr. 1275-77. Nevertheless, Respondents have demonstrated an inability to sustain such compliance efforts long term, and I find that they have not made sufficiently sincere assurances against future violations. Accordingly, all of the Steadman factors weigh against Respondents and in favor of a severe sanction.

B. Revocation of Investment Adviser Registrations

Section 203(e) of the Advisers Act authorizes the Commission to revoke an investment adviser's registration if it, or any person associated with it, has willfully violated, or willfully aided and abetted the violation of, any provision of the Advisers Act, and if revocation is in the public interest. In light of the Steadman Factors, Respondents must not be allowed to continue to serve as investment advisers, and their registrations will be permanently revoked.

C. Associational Bars

Section 203(f) of the Advisers Act authorizes the Commission to bar or suspend a person from association with an investment adviser for willful violations of the Advisers Act, if it is in the public interest. 15 U.S.C. § 80b-3(f). Section 15(b)(6) of the Exchange Act similarly authorizes the Commission to bar a person

from association with any broker or dealer, if the person has willfully violated any provision of the Advisers Act and it is in the public interest. 15 U.S.C. § 78o(b)(6)(A)(i); John W. Lawton, Advisers Act Release No. 3513 (Dec. 13, 2012), 105 SEC Docket 61722, 61737.[40]

Again, all Steadman factors weigh in favor of a permanent associational bar. Furthermore, it is in the Commission's interest to deter others from behaving like Lucia. In addition to intentionally misleading clients and prospective clients, Lucia refused to accept responsibility for the abdication of his fiduciary duty to his clients. He now tries to shift partial blame to the Commission for failing to detect problems in the 2003 slideshow. Therefore, it is in the public interest to permanently bar Lucia from association with investment advisers, brokers, and dealers.

D. Cease-And-Desist

Advisers Act Section 203(k) authorizes the Commission to impose a cease-and-desist order for violations of the Advisers Act. See 15 U.S.C. §§ 80b-3(k). The Commission requires some likelihood of future violation before imposing a cease-and-desist order. KPMG Peat Marwick LLP, Exchange Act Release No. 43862 (Jan. 19, 2001), 54 S.E.C 1135, 1185, motion for reconsideration denied, Exchange Act Release No. 44050 (Mar. 5, 2001), 53 S.E.C. 1, pet. denied, 289 F.3d 109 (D.C. Cir. 2002). However, "a finding of a [past] violation raises a sufficient risk of future viola-

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[40] A broker-dealer bar in this case is, alternatively, direct (assuming Lucia is affiliated with Lucia Securities or seeks to become so in the future) or collateral (assuming Lucia is considered not affiliated with Lucia Securities).

tion," because "evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering him to cease and desist." Id. at 1185.

Respondents' egregious and repetitive misconduct in providing thousands of potential investor clients with misleading information, Lucia's current employment as an investment adviser and media presence, and his inability to satisfy his previous assurances against violative conduct presents sufficient risk of future violations. Respondents claim to have already ceased their violative conduct, which is the subject of their seventh affirmative defense. Tr. 1275-77; RJLC Answer, p. 8. Even assuming this is true, it is of little consequence. See Geiger v. SEC, 363 F.3d 481, 489 (D.C. Cir. 2004) (a single violation raises an inference that it will be repeated, especially when the misconduct is egregious and when the violator thinks he did nothing wrong); see also Hunter Adams, Exchange Act Release No. 51117 (Feb. 1, 2005), 84 SEC Docket 2928, 2929 n.6 (listing reasons why even duplicative injunctive relief may be warranted). Therefore, the imposition of a cease-and-desist order is warranted. In view of the fact that the associational bar and investment adviser registration revocation will presumably put Lucia out of business, I see no need to add the condition that Respondents disclose at any future seminars that they have been sanctioned for providing misleading performance data about BOM.

E. Civil Penalty

Under Section 203(i) of the Advisers Act, the Commission may impose a civil money penalty if a respondent willfully violated any provision of the Advisers Act, and if such penalty is in the public interest. 15 U.S.C. §§ 80b-3(i).

A three-tier system establishes the maximum civil money penalty that may be imposed for each violation found. Id. Where a respondent's misconduct involve fraud, deceit, or deliberate or reckless disregard of a regulatory requirement, and resulted in substantial pecuniary gain, the Commission may impose a "Third-Tier" penalty of up to $150,000 for each act or omission by an individual and $725,000 for an entity. Id.; 17 C.F.R. § 201.1004 (adjusting the statutory amounts for inflation). Within any particular tier, the Commission has the discretion to set the amount of the penalty. See Brendan E. Murray, Advisers Act Release No. 2809 (Nov. 21, 2008), 94 SEC Docket 11961, 11978; The Rockies Fund, Inc., Advisers Act Release No. 54892 (Dec. 7, 2006), 89 SEC Docket 1517, 1528.

In determining whether a penalty is in the public interest, the Commission may consider (1) whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, (2) the resulting harm to other persons, (3) any unjust enrichment and prior restitution, (4) the respondent's prior regulatory record, (5) the need to deter the respondent and other persons, and (6) such other matters as justice may require. 15 U.S.C. § 80b-3(i); Murray, 94 SEC Docket at 11978.

I find a third-tier penalty to be warranted and in the public interest. Respondents acted deceitfully and disregarded the law intentionally. This factor is particularly important given the recurrence of Respondents' deceitful conduct, and the substantial financial success Respondents have enjoyed at their clients' expense. Also, the need to deter Respondents is strong, given Lucia's continued employment in the financial sector and his failure to acknowledge the wrongfulness of his conduct. See Murray, 94 SEC Docket at

11978. Sanctions imposed on Respondents will also deter others from engaging in the same misconduct. Id.

Nonetheless, the Division's requested penalty is excessive. Although the tier determines the maximum penalty, "each case has its own particular facts and circumstances which determine the appropriate penalty to be imposed" within the tier. SEC v. Murray, No. OS-CV-4643 (MKB), 2013 WL 839840, at *3 (E.D.N.Y. Mar. 6, 2013) (quotation omitted); see also SEC v. Kern, 425 F.3d 143, 153 (2d Cir. 2005). In addition to the statutory factors cited above, courts consider:

> (1) the egregiousness of the violations at issue, (2) defendants' scienter, (3) the repeated nature of the violations, (4) defendants' failure to admit to their wrongdoing; (5) whether defendants' conduct created substantial losses or the risk of substantial losses to other persons; (6) defendants' lack of cooperation and honesty with authorities, if any; and (7) whether the penalty that would otherwise be appropriate should be reduced due to [respondents'] demonstrated current and future financial condition.

SEC v. Lybrand, 281 F. Supp. 2d 726, 730 (S.D.N.Y. 2003), aff'd on other grounds, 425 F.3d 143 (2d Cir. 2005) (Lybrand factors).

Most of the Lybrand factors weigh in favor of a severe sanction. Nonetheless, although the "dissemination of false and misleading financial information by its nature causes serious harm to investors and the marketplace," in this case the evidence of actual losses to individual investors is virtually nonexistent. The

Rockies Fund, 89 SEC Docket at 1527. Chisholm complained of being unable to liquidate his REIT, and DeSipio filed an arbitration which was later dismissed. But there is no evidence of the amount of any unjust enrichment as to any particular investor. Additionally, Respondents have a clean regulatory record and were cooperative with examiners and investigators. Accordingly, I believe the maximum civil penalty is too high, and a civil penalty of about one-third of the maximum is justified.

The Division requests that the third-tier civil penalty be imposed one time, for each Respondent. While the statute provides that a penalty may be imposed for "each act or omission," it leaves the precise unit of violation undefined. See Colin S. Diver, The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies, 79 Colum. L. Rev. 1435, 1440-41 (1979). Although Respondents technically violated the statute hundreds of times, a one-time penalty prejudices them the least.[41] Therefore, a one-time, third-tier $250,000 penalty for RJLC and $50,000 penalty for Lucia is warranted.

TRANSCRIPT CORRECTIONS

On February 1, 2013, Respondents submitted a Motion re Proposed Transcript Corrections to the Hearing Transcript (Transcript Motion). The Division filed its Objections thereto on February 25, 2013. Respondents did not file a reply.

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[41] Assuming, hypothetically, that Lucia gave forty seminars a year for the three years actionable under the statute of limitations, at most RJLC would be subject to an $87 million penalty and Lucia would be subject to an $18 million penalty. Such penalties would plainly be disproportionate and unreasonable.

With two exceptions, the proposed corrections generally pertain to clear typographic or scrivener's errors, and they will be adopted. The first exception is the proposed change of "were back tests" to "were not back tests," in a statement made by Respondents' counsel in reference to Bennett's testimony. Transcript Motion, p. 1 (citing Tr. 209:17). Although I agree with the Division that the referenced testimony is found at Tr. 99:25-100:3, I do not agree that the proposed change would mischaracterize Bennett's testimony. To the contrary, the proposed change would harmonize Respondents' counsel's statement with Bennett's testimony. The second exception is the proposed change of "him" to "me" on one page. Tr. 792:17. In fact, the transcript already says "me," and in context the word should clearly read "him." Id. Accordingly, the Transcript Motion is granted in part, the proposed corrections are adopted as outlined above, and the "me" on page 792, line 17 is ordered changed to "him."

RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the Record Index issued by the Secretary of the Commission on April 19, 2013, and five documents filed since then: the July 8, 2013, Initial Decision; Respondents' Motion to Correct Manifest Errors of Fact, filed July 18, 2013; the Division's Opposition thereto, filed July 25, 2013; my Order on Motion to Correct Manifest Errors of Fact, filed August 7, 2013; and the Remand Order, filed August 8, 2013.

ORDER

IT IS ORDERED that, pursuant to Section 203(e) of the Advisers Act, the registrations of Raymond J. Lucia Companies, Inc. and Raymond J. Lucia, Sr. as investment advisers are REVOKED.

IT IS FURTHER ORDERED that, pursuant to Section 203(f) of the Advisers Act and Section 15(b) of the Exchange Act, Raymond J. Lucia, Sr. is permanently BARRED from association with investment advisers, brokers, or dealers.

IT IS FURTHER ORDERED that, pursuant to Section 203(k) of the Advisers Act, Raymond J. Lucia Companies, Inc. shall CEASE AND DESIST from committing, and Raymond J. Lucia, Sr. shall CEASE AND DESIST from aiding and abetting or causing the commission of, any violations or future violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act.

IT IS FURTHER ORDERED that, pursuant to Section 203(i) of the Advisers Act, Raymond J. Lucia, Sr. shall PAY A CIVIL MONEY PENALTY in the amount of $50,000.

IT IS FURTHER ORDERED that, pursuant to Section 203(i) of the Advisers Act, Raymond J. Lucia Companies, Inc. shall PAY A CIVIL MONEY PENALTY in the amount of $250,000.

IT IS FURTHER ORDERED that Respondents' Motion re Proposed Transcript Corrections to the Hearing Transcript is GRANTED IN PART, all proposed corrections except the proposed correction to page 792, line 17, are adopted, and the "me" on page 792, line 17 of the transcript is ORDERED changed to "him.".

Payment of penalties and disgorgement plus prejudgment interest shall be made on the first day following the day this Initial Decision becomes final. Payment shall be made by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission. The payment, and a cover letter identifying the Respondent(s) and Administrative Proceeding No. 3-15006, shall be delivered to: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct manifest error of fact or the Commission determines on its own initiative to review the In-

itial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Cameron Elliot
Administrative Law Judge

APPENDIX F

ADMINISTRATIVE PROCEEDING
File No. 3-15006

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION
August 8, 2013

In the Matter of RAYMOND J. LUCIA COMPANIES, INC. and RAYMOND J. LUCIA, SR.	ORDER REMANDING CASE FOR ISSUANCE OF AN INITIAL DECISION PURSUANT TO RULE OF PRACTICE 360

On September 5, 2012, the Commission instituted administrative proceedings against the above-named respondents pursuant to Section 15(b) of the Securities Exchange Act of 1934, Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940.[1] On July 8, 2013, the administrative law judge issued an Initial Decision concluding that Raymond J. Lucia Companies, Inc. ("RJLC"), a registered investment adviser had violated Sections 206(1), 206(2), and 206(4) of the Advisers Act and that Raymond J. Lucia, RJLC's sole owner and also a registered investment

[1] *Raymond J. Lucia Cos.*, Exchange Act Rel. No. 67781, Advisers Act Rel. No. 3456, Investment Company Act Rel. No. 30193, 2012 WL 3838150 (Sept. 5, 2012); *see* 15 U.S.C. §§ 78o(b), 80a-9(b), 80b-3(e), 80b-3(f), 80b-3(k).

adviser, had willfully aided and abetted those violations.[2]

The time for the parties to petition for review of the Initial Decision has not yet expired.[3] On our own initiative, we have determined that it is appropriate to remand the matter to the law judge for further consideration because the Initial Decision did not make findings with respect to all of the material allegations set forth in the Order Instituting Proceedings ("OIP") and presented for decision by the parties.

The OIP alleged that Respondents misrepresented to prospective investors the validity of the backtesting that they performed on their "Buckets of Money" ("BOM") investment strategy.[4] It identified four principal respects in which Respondents' backtesting allegedly was misleading. *First*, Respondents used a hypothetical 3% inflation rate, which was lower than the historically accurate inflation rates that prevailed during the 1970s and 1980s.[5] *Second*, Respondents used hypothetical rates of return for real estate investment trusts ("REITs") without disclosing that such returns would not have been available.[6] *Third*, Respondents did not disclose that the backtested returns did not take into account advisory

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[2] *Raymond J. Lucia Cos.*, Initial Decision Rel. No. 495, 2013 WL 3379719 (July 8, 2013).

[3] Rule of Practice 410(b) provides that a petition for review "shall be filed with the Commission within such time after service of the initial decision as prescribed by the hearing officer . . . unless a party has filed a motion to correct an initial decision with the hearing officer," which Respondents did here. 17 C.F.R. § 201.410(b).

[4] OIP ¶ 5.

[5] *Id.* ¶¶ 19-20, 22.

[6] *Id.* ¶¶ 21-22.

fees.[7] *Fourth*, Respondents did not disclose that the backtested portfolios had not been reallocated between asset categories over time in accordance with the BOM strategy.[8]

In view of these allegations, we deemed "it necessary and appropriate in the public interest that public administrative and cease-and-desist proceedings be instituted to determine," *inter alia*, "[w]hether the allegations set forth [in the OIP] . . . are true and, in connection therewith, to afford Respondents an opportunity to establish any defenses to such allegations."[9] We directed the law judge to issue an initial decision no later than 300 days from the date of service of the OIP pursuant to Rule 360(a)(2) of the Rules of Practice.[10]

After a nine-day hearing, the parties submitted post-hearing briefs that addressed at length each of the claims set forth in the OIP.[11] Yet the Initial Decision made findings with respect to only one claim—that pertaining to backtested returns on portfolios containing REITs. In explaining his decision, the law judge stated: "Out of the four misrepresentations that the OIP alleges violate the Advisers Act, I find the [Respondents'] presentation's use and depiction of 'backtests' with REITs, by itself, misleading. Also, the sanction imposed would not change even if [I] were to find merit to the remaining allegations. I therefore do

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[7] *Id.* ¶¶ 23-25.

[8] *Id.* ¶¶ 26-27.

[9] *Id.* § III(A).

[10] *Id.* § IV.

[11] *E.g.*, Division's Post-Hearing Brief at 14-16 (inflation), 16-18 (REITs), 18-19 (fees), 19-21 (reallocation); Respondents' Post-Hearing Brief at 38-43 (inflation), 43-46 (REITs), 46-49 (fees), 49-52 (reallocation).

not make any findings as to the other three alleged misrepresentations."[12]

We have previously described the vital role that initial decisions play in the Commission's decisional process. "Unlike the law judge, we have not observed the parties and witnesses who appeared and testified at the . . . hearing. As the presiding officer at the hearing, the law judge is in the best position to make findings of fact, including credibility determinations, and resolve any conflicts in the evidence. Our review of the record cannot replace the law judge's personal experience with the witnesses."[13]

It is a matter of considerable importance, therefore, that initial decisions comply fully with Rule of Practice 360(b), which provides that such decisions "shall include[] findings and conclusions, and the reasons or basis therefor, as to *all* the *material* issues of fact, law or discretion *presented on the record* and the appropriate order, sanction, relief, or denial thereof."[14] Indeed, because the Advisers Act calibrates maximum civil penalties based upon a certain dollar amount for

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[12] Initial Decision, 2013 WL 3379719, at *2. The Initial Decision imposed a cease-and-desist order and a permanent associational bar, revoked Lucia's and RJLC's investment adviser registrations, and imposed civil penalties of $50,000 on Lucia and $250,000 on RJLC. *Id.* at *37-41. The Division of Enforcement had sought a greater civil penalty, but the law judge found the requested penalty to be excessive given the paucity of evidence of actual losses to investors, Respondents' otherwise clean regulatory record, and their cooperation with examiners. *Id.* at *41.

[13] *Nasdaq Stock Market, LLC*, Exchange Act Rel. No. 57741, 93 S.E.C. Docket 301, 2008 WL 1902073, at *1 (Apr. 30, 2008).

[14] 17 C.F.R. § 360(b) (emphases added). It bears noting, though, that Rule 360(b) does *not* require that law judges, in every instance, make specific findings as to every fact that the parties place in dispute or may consider pertinent.

"*each* act . . . or omission,"[15] and because we have repeatedly held that the determination of a proper sanction "rests on a careful consideration of each of the factors" enumerated in our precedent, "taking into account all of a respondent's arguments[]" and weighing the factors "against each other under the *specific facts and circumstances of each case,*"[16] the findings that a law judge makes in the course of disposing of all claims well might inform our determination of the appropriate sanction in the event of any appeal.[17] Moreover, even if no party chooses to seek review, the law judge's findings would assist our determination of whether to order review on own initiative pursuant to Rule of Practice 411(c).[18] Finally, we note that securing law judges' rulings on all claims presented for decision would facilitate the prompt resolution of administrative proceedings and avoid piecemeal litigation

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[15] 15 U.S.C. § 80b-3(i)(2) (emphasis added).

[16] *Impax Labs, Inc.*, Exchange Act Rel. No. 57864, 93 S.E.C. Docket 853, 2008 WL 2167956, at *11 (May 23, 2008); *see, e.g., John W. Lawton,* Advisers Act Rel. No. 3513, 2012 WL 6208750, at *9 n.42 (Dec. 13, 2012) ("sanctions determinations should show 'individual attention to the unique facts and circumstances of [the] case'"); *Janet Gurley Katz,* Exchange Act Rel. No. 61449, 97 S.E.C. Docket 2447, 2010 WL 358737 at *26 n.64 (Feb. 1, 2010) ("The appropriate sanction depends on the facts and circumstances of each particular case.") (quotation marks omitted).

[17] *Cf United States v. Fumo*, 655 F.3d 288, 311 (3d Cir. 2011) (holding, in the criminal sentencing context, that a "court should not refuse to find or calculate a loss" when doing so is necessary to determining the appropriate sentencing range under the Federal Sentencing Guidelines); *United States v. Robinson*, 435 F.3d 699, 701 (7th Cir. 2006) (similar).

[18] 17 C.F.R. § 201.411 (c); *see, e.g., Hunter Adams,* Exchange Act Rel. No. 52859, 86 S.E.C. Docket 1958, 2005 WL 3240600, at *1 & n.6 (Nov. 30, 2005); *Derek L. DuBois*, Securities Act Rel. No. 8264, Exchange Act Rel. No. 48332, 80 S.E.C. Docket 2403, 2003 WL 21946858, at *1, 5 (Aug. 13, 2003).

and appeals.[19] When claims are left unaddressed by an initial decision, and our subsequent review discerns error as to the resolution of the claims that were addressed, the law judge will have to spend additional time and effort on remand re-examining issues that could have been disposed of earlier.

The Initial Decision did not fully resolve the claims set forth in the OIP as to which the parties joined issue and then presented for decision. Accordingly, IT IS ORDERED that the matter be, and it hereby is, remanded to the law judge for issuance of an initial decision pursuant to Rule 360(b); and it is further ORDERED that the initial decision be filed with the Secretary of the Commission within 120 days from the date of this remand order.

By the Commission.

/s/
Elizabeth M. Murphy
Secretary

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[19] *Cf. Phifer v. Warden, U.S. Penitentiary, Terre Haute, Ind.*, 53 F.3d 859, 863 (7th Cir. 1995) (noting, in the *habeas corpus* context, that "[o]rdinarily, a district court should try to rule upon all of the grounds presented in a habeas petition," because "[g]ranting a writ but leaving claims unresolved fails to take the possibility of reversal on appeal into account; should an appellate court reverse the conditional grant of the writ, a petitioner's remaining claims will have to be addressed"); *Clisby v. Jones*, 960 F.2d 925, 936 (11th Cir. 1992) (en banc) (similar).

APPENDIX G

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 15-1345 **September Term, 2016**

SEC-3-15006

Filed On: February 16, 2017

Raymond J. Lucia Companies, Inc. and
Raymond J. Lucia,

Petitioners

v.

Securities and Exchange Commission,

Respondent

BEFORE: Garland*, Chief Judge; Henderson, Rogers, Tatel, Brown, Griffith, Kavanaugh, Srinivasan, Millett, Pillard, and Wilkins, Circuit Judges

ORDER

Upon consideration of petitioners' petition for rehearing en banc, the response thereto, and the vote in favor of the petition by a majority of judges eligible to participate, it is

*Chief Judge Garland did not participate in this matter.

ORDERED the petition be granted. Case No. 15-1345 will be reheard by the court sitting en banc. It is

FURTHER ORDERED that the judgment filed August 9, 2016 be vacated. It is

FURTHER ORDERED that oral argument before the en banc court be heard on Wednesday, May 24, 2017, in Courtroom # 20, Sixth Floor. It is

FURTHER ORDERED that, in addition to filing briefs electronically, the parties file 30 paper copies of each of their final briefs and the deferred appendix, in accordance with the following schedule:

Initial Brief for Petitioners	March 10, 2017
Initial Brief(s) for Amici Curiae	March 10, 2017
Initial Brief for Respondent	March 31, 2017
Initial Brief(s) for Amici Curiae, if any	March 31, 2017
Initial Reply Brief for Petitioners	April 10, 2017
Deferred Appendix	April 17, 2017
Final Briefs	April 24, 2017

The briefs are to be limited to the following issues:

1. Is the SEC administrative law judge who handled this case an inferior officer rather than an employee for the purposes of the Appointments Clause of Article II of the Constitution?

2. Should the court overrule *Landry v. FDIC*, 204 F.3d 1125 (D.C. Cir. 2000)?

Parties are directed to hand deliver the paper copies of their submissions to the Clerk's office by the

date due. To enhance the clarity of their briefs, the parties are urged to limit the use of abbreviations, including acronyms. While acronyms may be used for entities and statutes with widely recognized initials, briefs should not contain acronyms that are not widely known. *See D.C. Circuit Handbook of Practice and Internal Procedures* 41 (2017); Notice Regarding Use of Acronyms (D.C. Cir. Jan. 26, 2010).

Because the briefing schedule is keyed to the date of oral argument, the court will grant requests for extension of time limits only for extraordinarily compelling reasons. The briefs and appendix must contain the date the case is scheduled for oral argument at the top of the cover. *See* D.C. Cir. Rule 28(a)(8).

Separate order(s) will issue scheduling the time of oral argument and allocating oral argument time.

Per Curiam

FOR THE COURT:

Mark J. Langer, Clerk

BY: /s/
Michael C. McGrail
Deputy Clerk

APPENDIX H

U.S. Const. art. II, sec. 2

The President shall be Commander in Chief of the Army and Navy of the United States, and of the Militia of the several States, when called into the actual Service of the United States; he may require the Opinion, in writing, of the principal Officer in each of the executive Departments, upon any Subject relating to the Duties of their respective Offices, and he shall have Power to Grant Reprieves and Pardons for Offences against the United States, except in Cases of Impeachment.

He shall have Power, by and with the Advice and Consent of the Senate, to make Treaties, provided two thirds of the Senators present concur; and he shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

The President shall have Power to fill up all Vacancies that may happen during the Recess of the Senate, by granting Commissions which shall expire at the End of their next Session.

5 U.S.C. § 556. Hearings; presiding employees; powers and duties; burden of proof; evidence; record as basis of decision

(a) This section applies, according to the provisions thereof, to hearings required by section 553 or 554 of this title to be conducted in accordance with this section.

(b) There shall preside at the taking of evidence—

(1) the agency;

(2) one or more members of the body which comprises the agency; or

(3) one or more administrative law judges appointed under section 3105 of this title.

This subchapter does not supersede the conduct of specified classes of proceedings, in whole or in part, by or before boards or other employees specially provided for by or designated under statute. The functions of presiding employees and of employees participating in decisions in accordance with section 557 of this title shall be conducted in an impartial manner. A presiding or participating employee may at any time disqualify himself. On the filing in good faith of a timely and sufficient affidavit of personal bias or other disqualification of a presiding or participating employee, the agency shall determine the matter as a part of the record and decision in the case.

(c) Subject to published rules of the agency and within its powers, employees presiding at hearings may—

(1) administer oaths and affirmations;

(2) issue subpenas authorized by law;

(3) rule on offers of proof and receive relevant evidence;

(4) take depositions or have depositions taken when the ends of justice would be served;

(5) regulate the course of the hearing;

(6) hold conferences for the settlement or simplification of the issues by consent of the parties or by the use of alternative means of dispute resolution as provided in subchapter IV of this chapter;

(7) inform the parties as to the availability of one or more alternative means of dispute resolution, and encourage use of such methods;

(8) require the attendance at any conference held pursuant to paragraph (6) of at least one representative of each party who has authority to negotiate concerning resolution of issues in controversy;

(9) dispose of procedural requests or similar matters;

(10)make or recommend decisions in accordance with section 557 of this title; and

(11)take other action authorized by agency rule consistent with this subchapter.

(d) Except as otherwise provided by statute, the proponent of a rule or order has the burden of proof. Any oral or documentary evidence may be received, but the agency as a matter of policy shall provide for the exclusion of irrelevant, immaterial, or unduly repetitious evidence. A sanction may not be imposed or rule or order issued except on consideration of the whole record or those parts thereof cited by a party and supported by and in accordance with the reliable,

probative, and substantial evidence. The agency may, to the extent consistent with the interests of justice and the policy of the underlying statutes administered by the agency, consider a violation of section 557(d) of this title sufficient grounds for a decision adverse to a party who has knowingly committed such violation or knowingly caused such violation to occur. A party is entitled to present his case or defense by oral or documentary evidence, to submit rebuttal evidence, and to conduct such cross-examination as may be required for a full and true disclosure of the facts. In rule making or determining claims for money or benefits or applications for initial licenses an agency may, when a party will not be prejudiced thereby, adopt procedures for the submission of all or part of the evidence in written form.

(e) The transcript of testimony and exhibits, together with all papers and requests filed in the proceeding, constitutes the exclusive record for decision in accordance with section 557 of this title and, on payment of lawfully prescribed costs, shall be made available to the parties. When an agency decision rests on official notice of a material fact not appearing in the evidence in the record, a party is entitled, on timely request, to an opportunity to show the contrary.

5 U.S.C. § 557. Initial decisions; conclusiveness; review by agency; submissions by parties; contents of decisions; record

(a) This section applies, according to the provisions thereof, when a hearing is required to be conducted in accordance with section 556 of this title.

(b) When the agency did not preside at the reception of the evidence, the presiding employee or, in

cases not subject to section 554(d) of this title, an employee qualified to preside at hearings pursuant to section 556 of this title, shall initially decide the case unless the agency requires, either in specific cases or by general rule, the entire record to be certified to it for decision. When the presiding employee makes an initial decision, that decision then becomes the decision of the agency without further proceedings unless there is an appeal to, or review on motion of, the agency within time provided by rule. On appeal from or review of the initial decision, the agency has all the powers which it would have in making the initial decision except as it may limit the issues on notice or by rule. When the agency makes the decision without having presided at the reception of the evidence, the presiding employee or an employee qualified to preside at hearings pursuant to section 556 of this title shall first recommend a decision, except that in rule making or determining applications for initial licenses—

(1) instead thereof the agency may issue a tentative decision or one of its responsible employees may recommend a decision; or

(2) this procedure may be omitted in a case in which the agency finds on the record that due and timely execution of its functions imperatively and unavoidably so requires.

(c) Before a recommended, initial, or tentative decision, or a decision on agency review of the decision of subordinate employees, the parties are entitled to a reasonable opportunity to submit for the consideration of the employees participating in the decisions—

(1) proposed findings and conclusions; or

(2) exceptions to the decisions or recommended decisions of subordinate employees or to tentative agency decisions; and

(3) supporting reasons for the exceptions or proposed findings or conclusions.

The record shall show the ruling on each finding, conclusion, or exception presented. All decisions, including initial, recommended, and tentative decisions, are a part of the record and shall include a statement of—

(A) findings and conclusions, and the reasons or basis therefor, on all the material issues of fact, law, or discretion presented on the record; and

(B) the appropriate rule, order, sanction, relief, or denial thereof.

(d)(1) In any agency proceeding which is subject to subsection (a) of this section, except to the extent required for the disposition of ex parte matters as authorized by law—

(A) no interested person outside the agency shall make or knowingly cause to be made to any member of the body comprising the agency, administrative law judge, or other employee who is or may reasonably be expected to be involved in the decisional process of the proceeding, an ex parte communication relevant to the merits of the proceeding;

(B) no member of the body comprising the agency, administrative law judge, or other employee who is or may reasonably be expected to be involved in the decisional process of the proceeding, shall make or knowingly cause to be made to any interested person outside the agency an ex parte communication relevant to the merits of the proceeding;

(C) a member of the body comprising the agency, administrative law judge, or other employee who is or may reasonably be expected to be involved in the decisional process of such proceeding who receives, or who makes or knowingly causes to be made, a communication prohibited by this subsection shall place on the public record of the proceeding:

(i) all such written communications;

(ii) memoranda stating the substance of all such oral communications; and

(iii) all written responses, and memoranda stating the substance of all oral responses, to the materials described in clauses (i) and (ii) of this subparagraph;

(D) upon receipt of a communication knowingly made or knowingly caused to be made by a party in violation of this subsection, the agency, administrative law judge, or other employee presiding at the hearing may, to the extent consistent with the interests of justice and the policy of the underlying statutes, require the party to show cause why his claim or interest in the proceeding should not be dismissed, denied, disregarded, or otherwise adversely affected on account of such violation; and

(E) the prohibitions of this subsection shall apply beginning at such time as the agency may designate, but in no case shall they begin to apply later than the time at which a proceeding is noticed for hearing unless the person responsible for the communication has knowledge that it will be noticed, in which case the prohibitions shall apply beginning at the time of his acquisition of such knowledge.

(2) This subsection does not constitute authority to withhold information from Congress.

5 U.S.C. § 3105. Appointment of administrative law judges

Each agency shall appoint as many administrative law judges as are necessary for proceedings required to be conducted in accordance with sections 556 and 557 of this title. Administrative law judges shall be assigned to cases in rotation so far as practicable, and may not perform duties inconsistent with their duties and responsibilities as administrative law judges.

5 U.S.C. § 5372. Administrative law judges

(a) For the purposes of this section, the term "administrative law judge" means an administrative law judge appointed under section 3105.

(b)(1)(A) There shall be 3 levels of basic pay for administrative law judges (designated as AL–1, 2, and 3, respectively), and each such judge shall be paid at 1 of those levels, in accordance with the provisions of this section.

(B) Within level AL–3, there shall be 6 rates of basic pay, designated as AL–3, rates A through F, respectively. Level AL–2 and level AL–1 shall each have 1 rate of basic pay.

(C) The rate of basic pay for AL–3, rate A, may not be less than 65 percent of the rate of basic pay for level IV of the Executive Schedule, and the rate of basic pay for AL–1 may not exceed the rate for level IV of the Executive Schedule.

(2) The Office of Personnel Management shall determine, in accordance with procedures which the Office shall by regulation prescribe, the level in which each administrative-law-judge position shall be placed and the qualifications to be required for appointment to each level.

(3)(A) Upon appointment to a position in AL–3, an administrative law judge shall be paid at rate A of AL–3, and shall be advanced successively to rates B, C, and D of that level at the beginning of the next pay period following completion of 52 weeks of service in the next lower rate, and to rates E and F of that level at the beginning of the next pay period following completion of 104 weeks of service in the next lower rate.

(B) The Office of Personnel Management may provide for appointment of an administrative law judge in AL–3 at an advanced rate under such circumstances as the Office may determine appropriate.

(4) Subject to paragraph (1), effective at the beginning of the first applicable pay period commencing on or after the first day of the month in which an adjustment takes effect under section 5303 in the rates of basic pay under the General Schedule, each rate of basic pay for administrative law judges shall be adjusted by an amount determined by the President to be appropriate.

(c) The Office of Personnel Management shall prescribe regulations necessary to administer this section.

10 U.S.C. § 867. Art. 67. Review by the Court of Appeals for the Armed Forces

(a) The Court of Appeals for the Armed Forces shall review the record in—

(1) all cases in which the sentence, as affirmed by a Court of Criminal Appeals, extends to death;

(2) all cases reviewed by a Court of Criminal Appeals which the Judge Advocate General orders sent to the Court of Appeals for the Armed Forces for review; and

(3) all cases reviewed by a Court of Criminal Appeals in which, upon petition of the accused and on good cause shown, the Court of Appeals for the Armed Forces has granted a review.

(b) The accused may petition the Court of Appeals for the Armed Forces for review of a decision of a Court of Criminal Appeals within 60 days from the earlier of—

(1) the date on which the accused is notified of the decision of the Court of Criminal Appeals; or

(2) the date on which a copy of the decision of the Court of Criminal Appeals, after being served on appellate counsel of record for the accused (if any), is deposited in the United States mails for delivery by first-class certified mail to the accused at an address provided by the accused or, if no such address has been provided by the accused, at the latest address listed for the accused in his official service record.

The Court of Appeals for the Armed Forces shall act upon such a petition promptly in accordance with the rules of the court.

(c) In any case reviewed by it, the Court of Appeals for the Armed Forces may act only with respect to the findings and sentence as approved by the convening authority and as affirmed or set aside as incorrect in law by the Court of Criminal Appeals. In a case which the Judge Advocate General orders sent to the Court of Appeals for the Armed Forces, that action need be taken only with respect to the issues raised by him. In a case reviewed upon petition of the accused, that action need be taken only with respect to issues specified in the grant of review. The Court of Appeals for the Armed Forces shall take action only with respect to matters of law.

(d) If the Court of Appeals for the Armed Forces sets aside the findings and sentence, it may, except where the setting aside is based on lack of sufficient evidence in the record to support the findings, order a rehearing. If it sets aside the findings and sentence and does not order a rehearing, it shall order that the charges be dismissed.

(e) After it has acted on a case, the Court of Appeals for the Armed Forces may direct the Judge Advocate General to return the record to the Court of Criminal Appeals for further review in accordance with the decision of the court. Otherwise, unless there is to be further action by the President or the Secretary concerned, the Judge Advocate General shall instruct the convening authority to take action in accordance with that decision. If the court has ordered a rehearing, but the convening authority finds a rehearing impracticable, he may dismiss the charges.

15 U.S.C. § 77u. Hearings by Commission

All hearings shall be public and may be held before the Commission or an officer or officers of the Commission designated by it, and appropriate records thereof shall be kept.

15 U.S.C. § 78d–1. Delegation of functions by Commission

(a) Authorization; functions delegable; eligible persons; application of other laws

In addition to its existing authority, the Securities and Exchange Commission shall have the authority to delegate, by published order or rule, any of its functions to a division of the Commission, an individual Commissioner, an administrative law judge, or an employee or employee board, including functions with respect to hearing, determining, ordering, certifying, reporting, or otherwise acting as to any work, business, or matter. Nothing in this section shall be deemed to supersede the provisions of section 556(b) of title 5, or to authorize the delegation of the function of rulemaking as defined in subchapter II of chapter 5 of title 5, with reference to general rules as distinguished from rules of particular applicability, or of the making of any rule pursuant to section 78s(c) of this title.

(b) Right of review; procedure

With respect to the delegation of any of its functions, as provided in subsection (a) of this section, the Commission shall retain a discretionary right to review the action of any such division of the Commission, individual Commissioner, administrative law judge, employee, or employee board, upon its own initiative or upon petition of a party to or intervenor in

such action, within such time and in such manner as the Commission by rule shall prescribe. The vote of one member of the Commission shall be sufficient to bring any such action before the Commission for review. A person or party shall be entitled to review by the Commission if he or it is adversely affected by action at a delegated level which (1) denies any request for action pursuant to section 77h(a) or section 77h(c) of this title or the first sentence of section 78*l*(d) of this title; (2) suspends trading in a security pursuant to section 78*l*(k) of this title; or (3) is pursuant to any provision of this chapter in a case of adjudication, as defined in section 551 of title 5, not required by this chapter to be determined on the record after notice and opportunity for hearing (except to the extent there is involved a matter described in section 554(a)(1) through (6) of such title 5).

(c) Finality of delegated action

If the right to exercise such review is declined, or if no such review is sought within the time stated in the rules promulgated by the Commission, then the action of any such division of the Commission, individual Commissioner, administrative law judge, employee, or employee board, shall, for all purposes, including appeal or review thereof, be deemed the action of the Commission.

15 U.S.C. § 78v. Hearings by Commission

Hearings may be public and may be held before the Commission, any member or members thereof, or any officer or officers of the Commission designated by it, and appropriate records thereof shall be kept.

15 U.S.C. § 80a–40. Hearings by Commission

Hearings may be public and may be held before the Commission, any member or members thereof, or any officer or officers of the Commission designated by it, and appropriate records thereof shall be kept.

15 U.S.C. § 80b–12. Hearings

Hearings may be public and may be held before the Commission, any member or members thereof, or any officer or officers of the Commission designated by it, and appropriate records thereof shall be kept.

26 U.S.C. § 7443A. Special trial judges

(a) Appointment

The chief judge may, from time to time, appoint special trial judges who shall proceed under such rules and regulations as may be promulgated by the Tax Court.

(b) Proceedings which may be assigned to special trial judges

The chief judge may assign—

(1) any declaratory judgment proceeding,

(2) any proceeding under section 7463,

(3) any proceeding where neither the amount of the deficiency placed in dispute (within the meaning of section 7463) nor the amount of any claimed overpayment exceeds $10,000, and

(4) any other proceeding which the chief judge may designate,

to be heard by the special trial judges of the court.

(c) Authority to make court decision

The court may authorize a special trial judge to make the decision of the court with respect to any proceeding described in paragraph (1), (2), or (3) of subsection (b), subject to such conditions and review as the court may provide.

(d) Salary

Each special trial judge shall receive salary—

(1) at a rate equal to 90 percent of the rate for judges of the Tax Court, and

(2) in the same installments as such judges.

(e) Expenses for travel and subsistence

Subsection (d) of section 7443 shall apply to special trial judges subject to such rules and regulations as may be promulgated by the Tax Court.

ADMINISTRATIVE PROCEDURE ACT

[PUBLIC LAW 404—79TH CONGRESS]

[CHAPTER 324—2D SESSION]

[S. 7]

AN ACT To improve the administration of justice by prescribing fair administrative procedure

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE

SECTION 1. This Act may be cited as the "Administrative Procedure Act".

DEFINITIONS

SEC. 2. As used in this Act—

(a) AGENCY.—"Agency" means each authority (whether or not within or subject to review by another agency) of the Government of the United States other than Congress, the courts, or the governments of the possessions, Territories, or the District of Columbia. Nothing in this Act shall be construed to repeal delegations of authority as provided by law. Except as to the requirements of section 3, there shall be excluded from the operation of this Act (1) agencies composed of representatives of the parties or of representatives of organizations of the parties to the disputes determined by them, (2) courts martial and military commissions, (3) military or naval authority exercised in the field in time of war or in occupied territory, or (4) functions which by law expire on the termination of present hostilities, within any fixed period thereafter, or before July 1, 1947, and the functions conferred by the following statutes: Selective Training and Service Act of 1940; Contract Settlement Act of 1944; Surplus Property Act of 1944.

(b) PERSON AND PARTY.—"Person" includes individuals, partnerships, corporations, associations, or public or private organizations of any character other than agencies. "Party" includes any person or agency named or admitted as a party, or properly seeking and entitled as of right to be admitted as a party, in any

agency proceeding; but nothing herein shall be construed to prevent an agency from admitting any person or agency as a party for limited purposes.

(c) RULE AND RULE MAKING.—"Rule" means the whole or any part of any agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or to describe the organization, procedure, or practice requirements of any agency and includes the approval or prescription for the future of rates, wages, corporate or financial structures or reorganizations thereof, prices, facilities, appliances, services or allowances therefor or of valuations, costs, or accounting, or practices bearing upon any of the foregoing. "Rule making" means agency process for the formulation, amendment, or repeal of a rule.

(d) ORDER AND ADJUDICATION.—"Order" means the whole, or any part of the final disposition (whether affirmative, negative, injunctive, or declaratory in form) of any agency in any matter other than rule making but including licensing. "Adjudication" means agency process for the formulation of an order.

(e) LICENSE AND LICENSING.—"License" includes the whole or part of any agency permit, certificate, approval, registration, charter, membership, statutory exemption or other form of permission. "Licensing" includes agency process respecting the grant, renewal, denial, revocation, suspension, annulment, withdrawal, limitation amendment, modification, or conditioning of a license.

(f) SANCTION AND RELIEF.—"Sanction" includes the whole or part of any agency (1) prohibition, requirement, limitation, or other condition affecting the free-

dom of any person; (2) withholding of relief; (3) imposition of any form of penalty or fine; (4) destruction, taking, seizure, or withholding of property ; (5) assessment of damages, reimbursement, restitution, compensation, costs, charges, or fees; (6) requirement, revocation, or suspension of a license; or (7) taking of other compulsory or restrictive action. "Relief" includes the whole or part of any agency (1) grant of money, assistance, license, authority, exemption, exception, privilege, or remedy; (2) recognition of any claim, right, immunity, privilege, exemption, or exception; or (3) taking of any other action upon the application or petition of, and beneficial to, any person.

(g) AGENCY PROCEEDING AND ACTION.—"Agency proceeding" means any agency process as defined in subsections (c), (d), and (e) of this section. "Agency action" includes the whole or part of every agency rule, order, license, sanction, relief, or the equivalent or denial thereof, or failure to act.

PUBLIC INFORMATION

SEC. 3. Except to the extent that there is involved (1) any function of the United States requiring secrecy in the public interest or (2) any matter relating solely to the internal management of any agency—

(a) RULES.—Every agency shall separately state and currently publish in the Federal Register (1) descriptions of its central and field organization including delegations by the agency of final authority and the established places at which, and methods whereby, the public may secure information or make submittals or requests; (2) statements of the general course and method by which its functions are chan-

neled and determined, including the nature and requirements of all formal or informal procedures available as well as forms and instructions as to the scope and contents of all papers, reports, or examinations; and (3) substantive rules adopted as authorized by law and statements of general policy or interpretations formulated and adopted by the agency for the guidance of the public, but not rules addressed to and served upon named persons in accordance with law. No person shall in any manner be required to resort to organization or procedure not so published.

(b) OPINIONS AND ORDERS.—Every agency shall publish or, in accordance with published rule, make available to public inspection all final opinions or orders in the adjudication of cases (except those required for good cause to be held confidential and not cited as precedents) and all rules.

(c) PUBLIC RECORDS.—Save as otherwise required by statute, matters of official record shall in accordance with published rule be made available to persons properly and directly concerned except information held confidential for good cause found.

RULE MAKING

SEC. 4. Except to the extent that there is involved (1) any military, naval, or foreign affairs function of the United States or (2) any matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts—

(a) NOTICE.—General notice of proposed rule making shall be published in the Federal Register (unless all persons subject thereto are named and either personally served or otherwise have actual notice thereof

in accordance with law) and shall include (1) a statement of the time, place, and nature of public rule making proceedings; (2) reference to the authority under which the rule is proposed; and (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved. Except where notice or hearing is required by statute, this subsection shall not apply to interpretative rules, general statements of policy, rules of agency organization, procedure, or practice, or in any situation in which the agency for good cause finds (and incorporates the finding and a brief statement of the reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

(b) PROCEDURES.—After notice required by this section, the agency shall afford interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity to present the same orally in any manner; and, after consideration of all relevant matter presented, the agency shall incorporate in any rules adopted a concise general statement of their basis and purpose. Where rules are required by statute to be made on the record after opportunity for an agency hearing, the requirements of sections 7 and 8 shall apply in place of the provisions of this subsection.

(c) EFFECTIVE DATES.—The required publication or service of any substantive rule (other than one granting or recognizing exemption or relieving restriction or interpretative rules and statements of policy) shall be made not less than thirty days prior to the effective date thereof except as otherwise provided

by the agency upon good cause found and published with the rule.

(d) PETITIONS.—Every agency shall accord any interested person the right to petition for the issuance, amendment, or repeal of a rule.

ADJUDICATION

SEC. 5. In every case of adjudication required by statute to be determined on the record after opportunity for an agency hearing, except to the extent that there is involved (1) any matter subject to a subsequent trial of the law and the facts de novo in any court; (2) the selection or tenure of an officer or employee of the United States other than examiners appointed pursuant to section 11; (3) proceedings in which decisions rest solely on inspections, tests, or elections; (4) the conduct of military, naval, or foreign affairs functions; (5) cases in which an agency is acting as an agent for a court; and (6) the certification of employee representatives—

(a) NOTICE.—Persons entitled to notice of an agency hearing shall be timely informed of (1) the time, place, and nature thereof; (2) the legal authority and jurisdiction under which the hearing is to be held; and (3) the matters of fact and law asserted. In instances in which private persons are the moving parties, other parties to the proceeding shall give prompt notice of issues controverted in fact or law; and in other instances agencies may by rule require responsive pleading. In fixing the times and places for hearings, due regard shall be had for the convenience and necessity of the parties or their representatives.

(b) PROCEDURE.—The agency shall afford all interested parties opportunity for (1) the submission and

consideration of facts, arguments, offers of settlement, or proposals of adjustment where time, the nature of the proceeding, and the public interest permit, and (2) to the extent that the parties are unable so to determine any controversy by consent, hearing, and decision upon notice and in conformity with sections 7 and 8.

(c) SEPARATION OF FUNCTIONS.—The same officers who preside at the reception of evidence pursuant to section 7 shall make the recommended decision or initial decision required by section 8 except where such officers become unavailable to the agency. Save to the extent required for the disposition of ex parte matters as authorized by law, no such officer shall consult any person or party on any fact in issue unless upon notice and opportunity for all parties to participate; nor shall such officer be responsible to or subject to the supervision or direction of any officer, employee, or agent engaged in the performance of investigative or prosecuting functions for any agency. No officer, employee, or agent engaged in the performance of investigative or prosecuting functions for any agency in any case shall, in that or a factually related case, participate or advise in the decision, recommended decision, or agency review pursuant to section 8 except as witness or counsel in public proceedings. This subsection shall not apply in determining applications for initial licenses or to proceedings involving the validity or application of rates, facilities, or practices of public utilities or carriers; nor shall it be applicable in any manner to the agency or any member or members of the body comprising the agency.

(d) DECLARATORY ORDERS.—The agency is authorized in its sound discretion, with like effect as in the

case of other orders, to issue a declaratory order to terminate a controversy or remove uncertainty.

ANCILLARY MATTERS

SEC 6. Except as otherwise provided in this Act—

(a) APPEARANCE.—Any person compelled to appear in person before any agency or representative thereof shall be accorded the right to be accompanied, represented, and advised by counsel or, if permitted by the agency, by other qualified representative. Every party shall be accorded the right to appear in person or by or with counsel or other duly qualified representative in any agency proceeding. So far as the orderly conduct of public business permits, any interested person may appear before any agency or its responsible officers or employees for the presentation, adjustment, or determination of any issue, request, or controversy in any proceeding (interlocutory, summary, or otherwise) or in connection with any agency function. Every agency shall proceed with reasonable dispatch to conclude any matter presented to it except that due regard shall be had for the convenience and necessity of the parties or their representatives. Nothing herein shall be construed either to grant or to deny to any person who is not a lawyer the right to appear for or represent others before any agency or in any agency proceeding.

(b) INVESTIGATIONS.—No process, requirement of a report, inspection, or other investigative act or demand shall be issued, made, or enforced in any manner or for any purpose except as authorized by law. Every person compelled to submit data or evidence shall be entitled to retain or, on payment of lawfully prescribed costs, procure a copy or transcript thereof,

except that in a nonpublic investigatory proceeding the witness may for good cause be limited to inspection of the official transcript of his testimony.

(c) SUBPENAS.—Agency subpenas authorized by law shall be issued to any party upon request and, as may be required by rules of procedure, upon a statement or showing of general relevance and reasonable scope of the evidence sought. Upon contest the court shall sustain any such subpena or similar process or demand to the extent that it is found to be in accordance with law and, in any proceeding for enforcement, shall issue an order requiring the appearance of the witness or the production of the evidence or data within a reasonable time under penalty of punishment for contempt in case of contumacious failure to comply.

(d) DENIALS.—Prompt notice shall be given of the denial in whole or in part of any written application, petition, or other request of any interested person made in connection with any agency proceeding. Except in affirming a prior denial or where the denial is self-explanatory, such notice shall be accompanied by a simple statement of procedural or other grounds.

HEARINGS

SEC. 7. In hearings which section 4 or 5 requires to be conducted pursuant to this section—

(a) PRESIDING OFFICERS.—There shall preside at the taking of evidence (1) the agency, (2) one or more members of the body which comprises the agency, or (3) one or more examiners appointed as provided in this Act; but nothing in this Act shall be deemed to supersede the conduct of specified classes of proceed-

ings in whole or part by or before boards or other officers specially provided for by or designated pursuant to statute. The functions of all presiding officers and of officers participating in decisions in conformity with section 8 shall be conducted in an impartial manner. Any such officer may at any time withdraw if he deems himself disqualified; and, upon the filing in good faith of a timely and sufficient affidavit of personal bias or disqualification of any such officer, the agency shall determine the matter as a part of the record and decision in the case.

(b) HEARING POWERS.—Officers presiding at hearings shall have authority, subject to the published rules of the agency and within its powers, to (1) administer oaths and affirmations, (2) issue subpenas authorized by law, (3) rule upon offers of proof and receive relevant evidence, (4) take or cause depositions to be taken whenever the ends of justice would be served thereby, (5) regulate the course of the hearing, (6) hold conferences for the settlement or simplification of the issues by consent of the parties, (7) dispose of procedural requests or similar matters, (8) make decisions or recommend decisions in conformity with section 8, and (9) take any other action authorized by agency rule consistent with this Act.

(c) EVIDENCE.—Except as statutes otherwise provide, the proponent of a rule or order shall have the burden of proof. Any oral or documentary evidence may be received, but every agency shall as a matter of policy provide for the exclusion of irrelevant, immaterial, or unduly repetitious evidence and no sanction shall be imposed or rule or order be issued except upon consideration of the whole record or such portions thereof as may be cited by any party and as supported by and in accordance with the reliable, probative, and

substantial evidence. Every party shall have the right to present his case or defense by oral or documentary evidence, to submit rebuttal evidence, and to conduct such cross-examination as may be required for a full and true disclosure of the facts. In rule making or determining claims for money or benefits or applications for initial licenses any agency may, where the interest of any party will not be prejudiced thereby, adopt procedures for the submission of all or part of the evidence in written form.

(d) RECORD.—The transcript of testimony and exhibits, together with all papers and requests filed in the proceeding, shall constitute the exclusive record for decision in accordance with section 8 and, upon payment of lawfully prescribed costs, shall be made available to the parties. Where any agency decision rests on official notice of a material fact not appearing in the evidence in the record, any party shall on timely request be afforded an opportunity to show the contrary.

DECISIONS

SEC. 8. In cases in which a hearing is required to be conducted in conformity with section 7—

(a) ACTION BY SUBORDINATES.—In cases in which the agency has not presided at the reception of the evidence, the officer who presided (or, in cases not subject to subsection (c) of section 5, any other officer or officers qualified to preside at hearings pursuant to section 7) shall initially decide the case or the agency shall require (in specific cases or by general rule) the entire record to be certified to it for initial decision. Whenever such officers make the initial decision and

in the absence of either an appeal to the agency or review upon motion of the agency within time provided by rule, such decision shall without further proceedings then become the decision of the agency. On appeal from or review of the initial decisions of such officers the agency shall, except as it may limit the issues upon notice or by rule, have all the powers which it would have in making the initial decision. Whenever the agency makes the initial decision without having presided at the reception of the evidence, such officers shall first recommend a decision except that in rule making or determining applications for initial licenses (1) in lieu thereof the agency may issue a tentative decision or any of its responsible officers may recommend a decision or (2) any such procedure may be omitted in any case in which the agency finds upon the record that due and timely execution of its functions imperatively and unavoidably so requires.

(b) SUBMITTALS AND DECISIONS.—Prior to each recommended, initial, or tentative decision, or decision upon agency review of the decision of subordinate officers the parties shall be afforded a reasonable opportunity to submit for the consideration of the officers participating in such decisions (1) proposed findings and conclusions, or (2) exceptions to the decisions or recommended decisions of subordinate officers or to tentative agency decisions, and (3) supporting reasons for findings or such exceptions or proposed findings or conclusions. The record shall show the ruling upon each such finding, conclusion, or exception presented. All decisions (including initial, recommended, or tentative decisions) shall become a part of the record and include a statement of (1) findings and conclusions, as well as the reasons or basis therefor, upon all the material issues of fact, law, or discretion presented on the

record; and (2) the appropriate rule, order, sanction, relief, or denial thereof.

SANCTIONS AND POWERS

SEC. 9. In the exercise of any power or authority—

(a) IN GENERAL.—No sanction shall be imposed or substantive rule or order be issued except within jurisdiction delegated to the agency and as authorized by law.

(b) LICENSES.—In any case in which application is made for a license required by law the agency, with due regard to the rights or privileges of all the interested parties or adversely affected persons and with reasonable dispatch, shall set and complete any proceedings required to be conducted pursuant to sections 7 and 8 of this Act or other proceedings required by law and shall make its decision. Except in cases of willfulness or those in which public health, interest or safety requires otherwise, no withdrawal, suspension, revocation, or annulment of any license shall be lawful unless, prior to the institution of agency proceedings therefor, facts or conduct which may warrant such action shall have been called to the attention of the licensee by the agency in writing and the licensee shall have been accorded opportunity to demonstrate or achieve compliance with all lawful requirements. In any case in which the licensee has, in accordance with agency rules, made timely and sufficient application for a renewal or a new license, no license with reference to any activity of a continuing nature shall expire until such application shall have been finally determined by the agency.

JUDICIAL REVIEW

SEC. 10. Except so far as (1) statutes preclude judicial review or (2) agency action is by law committed to agency discretion—

(a) RIGHT OF REVIEW.—Any person suffering legal wrong because of any agency action, or adversely affected or aggrieved by such action within the meaning of any relevant statute, shall be entitled to judicial review thereof.

(b) FORM AND VENUE OR ACTION.—The form of proceeding for judicial review shall be any special statutory review proceeding relevant to the subject matter in any court specified by statute or, in the absence of inadequacy thereof, any applicable form of legal action (including actions for declaratory judgments or writs of prohibitory or mandatory injunction or habeas corpus) in any court of competent jurisdiction. Agency action shall be subject to judicial review in civil or criminal proceedings for judicial enforcement except to the extent that prior, adequate, and exclusive opportunity for such review is provided by law.

(c) REVIEWABLE ACTS.—Every agency action made reviewable by statute and every final agency action for which there is no other adequate remedy in any court shall be subject to judicial review. Any preliminary, procedural, or intermediate agency action or ruling not directly reviewable shall be subject to review upon the review of the final agency action. Except as otherwise expressly required by statute, agency action otherwise final shall be final for the purposes of this subsection whether or not there has been presented or determined any application for a declaratory order, for any form of reconsideration or (unless the agency

otherwise requires by rule and provides that the action meanwhile shall be inoperative) for an appeal to superior agency authority.

(d) INTERIM RELIEF.—Pending judicial review any agency is authorized, where it finds that justice so requires, to postpone the effective date of any action taken by it. Upon such conditions as may be required and to the extent necessary to prevent irreparable injury, every reviewing court (including every court to which a case may be taken on appeal from or upon application for certiorari or other writ to a reviewing court) is authorized to issue all necessary and appropriate process to postpone the effective date of any agency action or to preserve status or rights pending conclusion of the review proceedings.

(e) SCOPE OF REVIEW.—So far as necessary to decision and where presented the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of any agency action. It shall (A) compel agency action unlawfully withheld or unreasonably delayed; and (B) hold unlawful and set aside agency action, findings, and conclusions found to be (1) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; (2) contrary to constitutional right, power, privilege, or immunity; (3) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; (4) without observance of procedure required by law; (5) unsupported by substantial evidence in any case subject to the requirements of sections 7 and 8 or otherwise reviewed on the record of an agency hearing provided by statute; or (6) unwarranted by the facts to the extent that the facts are subject to trial de novo by

the reviewing court. In making the foregoing determinations the court shall review the whole record or such portions thereof as may be cited by any party, and due account shall be taken of the rule of prejudicial error.

EXAMINERS

SEC. 11. Subject to the civil-service and other laws to the extent not inconsistent with this Act, there shall be appointed by and for each agency as many qualified and competent examiners as may be necessary for proceedings pursuant to sections 7 and 8, who shall be assigned to cases in rotation so far as practicable and shall perform no duties inconsistent with their duties and responsibilities as examiners. Examiners shall be removable by the agency in which they are employed only for good cause established and determined by the Civil Service Commission (hereinafter called the Commission) after opportunity for hearing and upon the record thereof. Examiners shall receive compensation prescribed by the Commission independently of agency recommendations or ratings and in accordance with the Classification Act of 1923, as amended, except that the provisions of paragraphs (2) and (3) of subsection (b) of section 7 of said Act, as amended, and the provisions of section 9 of said Act, as amended, shall not be applicable. Agencies occasionally or temporarily insufficiently staffed may utilize examiners selected by the Commission from and with the consent of other agencies. For the purposes of this section, the Commission is authorized to make investigations, require reports by agencies, issue reports, including an annual report to the Congress, promulgate rules, appoint such advisory committees as may be deemed necessary, recommend legislation, subpena witnesses

or records, and pay witness fees as established for the United States courts.

CONSTRUCTION AND EFFECT

SEC. 12. Nothing in this Act shall be held to diminish the constitutional rights of any person or to limit or repeal additional requirements imposed by statute or otherwise recognized by law. Except as otherwise required by law, all requirements or privileges relating to evidence or procedure shall apply equally to agencies and persons. If any provision of this Act or the application thereof is held invalid, the remainder of this Act or other applications of such provision shall not be affected. Every agency is granted all authority necessary to comply with the requirements of this Act through the issuance of rules or otherwise. No subsequent legislation shall be held to supersede or modify the provisions of this Act except to the extent that such legislation shall do so expressly. This Act shall take effect three months after its approval except that sections 7 and 8 shall take effect six months after such approval, the requirement of the selection of examiners pursuant to section 11 shall not become effective until one year after such approval, and no procedural requirement shall be mandatory as to any agency proceeding initiated prior to the effective date of such requirement.

Approved June 11, 1946.

17 C.F.R. § 200.14 Office of Administrative Law Judges.

(a) Under the Administrative Procedure Act (5 U.S.C. 551–559) and the federal securities laws, the

Office of Administrative Law Judges conducts hearings in proceedings instituted by the Commission. The Administrative Law Judges are responsible for the fair and orderly conduct of the proceedings and have the authority to:

(1) Administer oaths and affirmations;

(2) Issue subpoenas;

(3) Rule on offers of proof;

(4) Examine witnesses;

(5) Regulate the course of a hearing;

(6) Hold pre-hearing conferences;

(7) Rule upon motions; and

(8) Unless waived by the parties, prepare an initial decision containing the conclusions as to the factual and legal issues presented, and issue an appropriate order.

(b) The Chief Administrative Law Judge performs the duties of an Administrative Law Judge under the Administrative Procedure Act and the duties delegated to him or her by the Commission that are compatible with those duties. The Chief Administrative Law Judge is responsible for the orderly functioning of the Office of Administrative Law Judges apart from the conduct of administrative proceedings and acts as liaison between that Office and the Commission.

17 C.F.R. § 201.110 Presiding officer.

All proceedings shall be presided over by the Commission or, if the Commission so orders, by a hearing

officer. When the Commission designates that the hearing officer shall be an administrative law judge, the Chief Administrative Law Judge shall select, pursuant to 17 CFR 200.30–10, the administrative law judge to preside.

17 C.F.R. § 201.111 Hearing officer: Authority.

The hearing officer shall have the authority to do all things necessary and appropriate to discharge his or her duties. No provision of these Rules of Practice shall be construed to limit the powers of the hearing officer provided by the Administrative Procedure Act, 5 U.S.C. 556, 557. The powers of the hearing officer include, but are not limited to, the following:

(a) Administering oaths and affirmations;

(b) Issuing subpoenas authorized by law and revoking, quashing, or modifying any such subpoena;

(c) Receiving relevant evidence and ruling upon the admission of evidence and offers of proof;

(d) Regulating the course of a proceeding and the conduct of the parties and their counsel;

(e) Holding prehearing and other conferences as set forth in § 201.221 and requiring the attendance at any such conference of at least one representative of each party who has authority to negotiate concerning the resolution of issues in controversy;

(f) Recusing himself or herself upon motion made by a party or upon his or her own motion;

(g) Ordering, in his or her discretion, in a proceeding involving more than one respondent, that the interested division indicate, on the record, at least one

day prior to the presentation of any evidence, each respondent against whom that evidence will be offered;

(h) Subject to any limitations set forth elsewhere in these Rules of Practice, considering and ruling upon all procedural and other motions, including a motion to correct a manifest error of fact in the initial decision. A motion to correct is properly filed under this Rule only if the basis for the motion is a patent misstatement of fact in the initial decision. Any motion to correct must be filed within ten days of the initial decision. A brief in opposition may be filed within five days of a motion to correct. The hearing officer shall have 20 days from the date of filing of any brief in opposition filed to rule on a motion to correct;

(i) Preparing an initial decision as provided in § 201.360;

(j) Upon notice to all parties, reopening any hearing prior to the filing of an initial decision therein, or, if no initial decision is to be filed, prior to the time fixed for the filing of final briefs with the Commission; and

(k) Informing the parties as to the availability of one or more alternative means of dispute resolution, and encouraging the use of such methods.

17 C.F.R. § 201.155 Default; motion to set aside default.

(a) A party to a proceeding may be deemed to be in default and the Commission or the hearing officer may determine the proceeding against that party upon consideration of the record, including the order

instituting proceedings, the allegations of which may be deemed to be true, if that party fails:

(1) To appear, in person or through a representative, at a hearing or conference of which that party has been notified;

(2) To answer, to respond to a dispositive motion within the time provided, or otherwise to defend the proceeding; or

(3) To cure a deficient filing within the time specified by the commission or the hearing officer pursuant to § 201.180(b).

(b) A motion to set aside a default shall be made within a reasonable time, state the reasons for the failure to appear or defend, and specify the nature of the proposed defense in the proceeding. In order to prevent injustice and on such conditions as may be appropriate, the hearing officer, at any time prior to the filing of the initial decision, or the Commission, at any time, may for good cause shown set aside a default.

17 C.F.R. § 201.180 Sanctions.

(a) *Contemptuous conduct*—(1) *Subject to exclusion or suspension.* Contemptuous conduct by any person before the Commission or a hearing officer during any proceeding, including any conference, shall be grounds for the Commission or the hearing officer to:

(i) Exclude that person from such hearing or conference, or any portion thereof; and/or

(ii) Summarily suspend that person from representing others in the proceeding in which such conduct occurred for the duration, or any portion, of the proceeding.

(2) *Review procedure.* A person excluded from a hearing or conference, or a counsel summarily suspended from practice for the duration or any portion of a proceeding, may seek review of the exclusion or suspension by filing with the Commission, within three days of the exclusion or suspension order, a motion to vacate the order. The Commission shall consider such motion on an expedited basis as provided in § 201.500.

(3) *Adjournment.* Upon motion by a party represented by counsel subject to an order of exclusion or suspension, an adjournment shall be granted to allow the retention of new counsel. In determining the length of an adjournment, the Commission or hearing officer shall consider, in addition to the factors set forth in § 201.161, the availability of co-counsel for the party or of other members of a suspended counsel's firm.

(b) *Deficient filings; leave to cure deficiencies.* The Commission or the hearing officer may reject, in whole or in part, any filing that fails to comply with any requirements of these Rules of Practice or of any order issued in the proceeding in which the filing was made. Any such filings shall not be part of the record. The Commission or the hearing officer may direct a party to cure any deficiencies and to resubmit the filing within a fixed time period.

(c) *Failure to make required filing or to cure deficient filing.* The Commission or the hearing officer

may enter a default pursuant to § 201.155, dismiss the case, decide the particular matter at issue against that person, or prohibit the introduction of evidence or exclude testimony concerning that matter if a person fails:

(1) To make a filing required under these Rules of Practice; or

(2) To cure a deficient filing within the time specified by the Commission or the hearing officer pursuant to paragraph (b) of this section.

17 C.F.R. § 201.232 Subpoenas.

(a) *Availability; procedure.* In connection with any hearing ordered by the Commission, a party may request the issuance of subpoenas requiring the attendance and testimony of witnesses at the designated time and place of hearing, and subpoenas requiring the production of documentary or other tangible evidence returnable at any designated time or place. Unless made on the record at a hearing, requests for issuance of a subpoena shall be made in writing and served on each party pursuant to § 201.150. A person whose request for a subpoena has been denied or modified may not request that any other person issue the subpoena.

(1) *Unavailability of hearing officer.* In the event that the hearing officer assigned to a proceeding is unavailable, the party seeking issuance of the subpoena may seek its issuance from the first available of the following persons: The Chief Administrative Law Judge, the law judge most senior in service as a law judge, the duty officer, any other member of the Com-

mission, or any other person designated by the Commission to issue subpoenas. Requests for issuance of a subpoena made to the Commission, or any member thereof, must be submitted to the Secretary, not to an individual Commissioner.

(2) *Signing may be delegated.* A hearing officer may authorize issuance of a subpoena, and may delegate the manual signing of the subpoena to any other person authorized to issue subpoenas.

(b) *Standards for issuance.* Where it appears to the person asked to issue the subpoena that the subpoena sought may be unreasonable, oppressive, excessive in scope, or unduly burdensome, he or she may, in his or her discretion, as a condition precedent to the issuance of the subpoena, require the person seeking the subpoena to show the general relevance and reasonable scope of the testimony or other evidence sought. If after consideration of all the circumstances, the person requested to issue the subpoena determines that the subpoena or any of its terms is unreasonable, oppressive, excessive in scope, or unduly burdensome, he or she may refuse to issue the subpoena, or issue it only upon such conditions as fairness requires. In making the foregoing determination, the person issuing the subpoena may inquire of the other participants whether they will stipulate to the facts sought to be proved.

(c) *Service.* Service shall be made pursuant to the provisions of § 201.150 (b) through (d). The provisions of this paragraph (c) shall apply to the issuance of subpoenas for purposes of investigations, as required by 17 CFR 203.8, as well as hearings.

(d) *Tender of fees required.* When a subpoena compelling the attendance of a person at a hearing or

deposition is issued at the instance of anyone other than an officer or agency of the United States, service is valid only if the subpoena is accompanied by a tender to the subpoenaed person of the fees for one day's attendance and mileage specified by paragraph (f) of this section.

(e) *Application to quash or modify.* (1) Any person to whom a subpoena is directed, or who is an owner, creator or the subject of the documents that are to be produced pursuant to a subpoena, or any party may, prior to the time specified therein for compliance, but in no event more than 15 days after the date of service of such subpoena, request that the subpoena be quashed or modified. Such request shall be made by application filed with the Secretary and served on all parties pursuant to § 201.150. The party on whose behalf the subpoena was issued may, within five days of service of the application, file an opposition to the application. If a hearing officer has been assigned to the proceeding, the application to quash shall be directed to that hearing officer for consideration, even if the subpoena was issued by another person.

(2) *Standards governing application to quash or modify.* If compliance with the subpoena would be unreasonable, oppressive or unduly burdensome, the hearing officer or the Commission shall quash or modify the subpoena, or may order return of the subpoena only upon specified conditions. These conditions may include but are not limited to a requirement that the party on whose behalf the subpoena was issued shall make reasonable compensation to the person to whom the subpoena was addressed for the cost of copying or transporting evidence to the place for return of the subpoena.

(f) *Witness fees and mileage.* Witnesses summoned before the Commission shall be paid the same fees and mileage that are paid to witnesses in the courts of the United States, and witnesses whose depositions are taken and the persons taking the same shall severally be entitled to the same fees as are paid for like services in the courts of the United States. Witness fees and mileage shall be paid by the party at whose instance the witnesses appear.

17 C.F.R. § 201.360 Initial decision of hearing officer.

(a)(1) *When required.* Unless the Commission directs otherwise, the hearing officer shall prepare an initial decision in any proceeding in which the Commission directs a hearing officer to preside at a hearing, provided, however, that an initial decision may be waived by the parties with the consent of the hearing officer pursuant to § 201.202.

(2) *Time period for filing initial decision.* In the order instituting proceedings, the Commission will specify a time period in which the hearing officer's initial decision must be filed with the Secretary. In the Commission's discretion, after consideration of the nature, complexity, and urgency of the subject matter, and with due regard for the public interest and the protection of investors, this time period will be either 120, 210 or 300 days from the date of service of the order. Under the 300-day timeline, the hearing officer shall issue an order providing that there shall be approximately 4 months from the order instituting the proceeding to the hearing, approximately 2 months for the parties to obtain the transcript and submit briefs, and approximately 4 months after briefing for the

hearing officer to issue an initial decision. Under the 210-day timeline, the hearing officer shall issue an order providing that there shall be approximately 2 ½ months from the order instituting the proceeding to the hearing, approximately 2 months for the parties to review the transcript and submit briefs, and approximately 2 ½ months after briefing for the hearing officer to issue an initial decision. Under the 120-day timeline, the hearing officer shall issue an order providing that there shall be approximately 1 month from the order instituting the proceeding to the hearing, approximately 2 months for the parties to review the transcript and submit briefs, and approximately 1 month after briefing for the hearing officer to issue an initial decision. These deadlines confer no substantive rights on respondents. If a stay is granted pursuant to § 201.210(c)(3), the time period specified in the order instituting proceedings in which the hearing officer's initial decision must be filed with the Secretary, as well as any other time limits established in orders issued by the hearing officer in the proceeding, shall be automatically tolled during the period while the stay is in effect.

(3) *Motion for extension.* In the event that the hearing officer presiding over the proceeding determines that it will not be possible to issue the initial decision within the specified period of time, the hearing officer should consult with the Chief Administrative Law Judge. Following such consultation, the Chief Administrative Law Judge may determine, in his or her discretion, to submit a motion to the Commission requesting an extension of the time period for filing the initial decision. This motion must be filed no later than 30 days prior to the expiration of the time specified in the order for issuance of an initial decision. The motion will be served upon all parties in the

proceeding, who may file with the Commission statements in support of or in opposition to the motion. If the Commission determines that additional time is necessary or appropriate in the public interest, the Commission shall issue an order extending the time period for filing the initial decision.

(b) *Content.* An initial decision shall include: Findings and conclusions, and the reasons or basis therefor, as to all the material issues of fact, law or discretion presented on the record and the appropriate order, sanction, relief, or denial thereof. The initial decision shall also state the time period, not to exceed 21 days after service of the decision, except for good cause shown, within which a petition for review of the initial decision may be filed. The reasons for any extension of time shall be stated in the initial decision. The initial decision shall also include a statement that, as provided in paragraph (d) of this section:

(1) The Commission will enter an order of finality as to each party unless a party or an aggrieved person entitled to review timely files a petition for review of the initial decision or a motion to correct a manifest error of fact in the initial decision with the hearing officer, or the Commission determines on its own initiative to review the initial decision; and

(2) If a party or an aggrieved person entitled to review timely files a petition for review or a motion to correct a manifest error of fact in the initial decision with the hearing officer, or if the Commission takes action to review as to a party or an aggrieved person entitled to review, the initial decision shall not become final as to that party or person.

(c) *Filing, service and publication.* The hearing officer shall file the initial decision with the Secretary.

The Secretary shall promptly serve the initial decision upon the parties and shall promptly publish notice of the filing thereof in the *SEC News Digest.* Thereafter, the Secretary shall publish the initial decision in the *SEC Docket*; provided, however, that in nonpublic proceedings no notice shall be published unless the Commission otherwise directs.

(d) *Finality.* (1) If a party or an aggrieved person entitled to review timely files a petition for review or a motion to correct a manifest error of fact in the initial decision, or if the Commission on its own initiative orders review of a decision with respect to a party or a person aggrieved who would be entitled to review, the initial decision shall not become final as to that party or person.

(2) If a party or aggrieved person entitled to review fails to file timely a petition for review or a motion to correct a manifest error of fact in the initial decision, and if the Commission does not order review of a decision on its own initiative, the Commission will issue an order that the decision has become final as to that party. The decision becomes final upon issuance of the order. The order of finality shall state the date on which sanctions, if any, take effect. Notice of the order shall be published in the *SEC Docket* and on the SEC Web site.

17 C.F.R. § 201.410 Appeal of initial decisions by hearing officers.

(a) *Petition for review; when available.* In any proceeding in which an initial decision is made by a hearing officer, any party, and any other person who would have been entitled to judicial review of the decision entered therein if the Commission itself had

made the decision, may file a petition for review of the decision with the Commission.

(b) *Procedure.* The petition for review of an initial decision shall be filed with the Commission within such time after service of the initial decision as prescribed by the hearing officer pursuant to § 201.360(b) unless a party has filed a motion to correct an initial decision with the hearing officer. If such correction has been sought, a party shall have 21 days from the date of the hearing officer's order resolving the motion to correct to file a petition for review. The petition shall set forth the specific findings and conclusions of the initial decision as to which exception is taken, together with supporting reasons for each exception. Supporting reasons may be stated in summary form. Any exception to an initial decision not stated in the petition for review, or in a previously filed proposed finding made pursuant to § 201.340 may, at the discretion of the Commission, be deemed to have been waived by the petitioner. In the event a petition for review is filed, any other party to the proceeding may file a cross-petition for review within the original time allowed for seeking review or within ten days from the date that the petition for review was filed, whichever is later.

(c) *Financial disclosure statement requirement.* Any person who files a petition for review of an initial decision that asserts that person's inability to pay either disgorgement, interest or a penalty shall file with the opening brief a sworn financial disclosure statement containing the information specified in § 201.630(b).

(d) [Reserved]

(e) *Prerequisite to judicial review.* Pursuant to Section 704 of the Administrative Procedure Act, 5 U.S.C. 704, a petition to the Commission for review of an initial decision is a prerequisite to the seeking of judicial review of a final order entered pursuant to such decision.

17 C.F.R. § 201.411 Commission consideration of initial decisions by hearing officers.

(a) *Scope of review.* The Commission may affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part, an initial decision by a hearing officer and may make any findings or conclusions that in its judgment are proper and on the basis of the record.

(b) *Standards for granting review pursuant to a petition for review*—(1) *Mandatory review.* After a petition for review has been filed, the Commission shall review any initial decision that:

(i) Denies any request for action pursuant to Section 8(a) or Section 8(c) of the Securities Act of 1933, 15 U.S.C. 77h(a), (c), or the first sentence of Section 12(d) of the Exchange Act, 15 U.S.C. 78*l*(d);

(ii) Suspends trading in a security pursuant to Section 12(k) of the Exchange Act, 15 U.S.C. 78l(k); or

(iii) Is in a case of adjudication (as defined in 5 U.S.C. 551) not required to be determined on the record after notice and opportunity for hearing (except to the extent there is involved a matter described in 5 U.S.C. 554(a) (1) through (6)).

(2) *Discretionary review.* The Commission may decline to review any other decision. In determining

whether to grant review, the Commission shall consider whether the petition for review makes a reasonable showing that:

(i) A prejudicial error was committed in the conduct of the proceeding; or

(ii) The decision embodies:

(A) A finding or conclusion of material fact that is clearly erroneous; or

(B) A conclusion of law that is erroneous; or

(C) An exercise of discretion or decision of law or policy that is important and that the Commission should review.

(c) *Commission review other than pursuant to a petition for review.* The Commission may, on its own initiative, order review of any initial decision, or any portion of any initial decision, within 21 days after the end of the period established for filing a petition for review pursuant to § 210.410(b). A party who does not intend to file a petition for review, and who desires the Commission's determination whether to order review on its own initiative to be made in a shorter time, may make a motion for an expedited decision, accompanied by a written statement that the party waives its right to file a petition for review. The vote of one member of the Commission, conveyed to the Secretary, shall be sufficient to bring a matter before the Commission for review.

(d) *Limitations on matters reviewed.* Review by the Commission of an initial decision shall be limited to the issues specified in the petition for review or the issues, if any, specified in the briefing schedule order issued pursuant to § 201.450(a). On notice to all parties, however, the Commission may, at any time prior

to issuance of its decision, raise and determine any other matters that it deems material, with opportunity for oral or written argument thereon by the parties.

(e) *Summary affirmance.* (1) At any time within 21 days after the filing of a petition for review pursuant to § 201.410(b), any party may file a motion in accordance with § 201.154 asking that the Commission summarily affirm an initial decision. Any party may file an opposition and reply to such motion in accordance with § 201.154. Pending determination of the motion for summary affirmance, the Commission, in its discretion, may delay issuance of a briefing schedule order pursuant to § 201.450.

(2) Upon consideration of the motion and any opposition or upon its own initiative, the Commission may summarily affirm an initial decision. The Commission may grant summary affirmance if it finds that no issue raised in the initial decision warrants consideration by the Commission of further oral or written argument. The Commission will decline to grant summary affirmance upon a reasonable showing that a prejudicial error was committed in the conduct of the proceeding or that the decision embodies an exercise of discretion or decision of law or policy that is important and that the Commission should review.

(f) *Failure to obtain a majority.* In the event a majority of participating Commissioners do not agree to a disposition on the merits, the initial decision shall be of no effect, and an order will be issued in accordance with this result.

APPENDIX I

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15519

In the Matter of	:
Timbervest, LLC,	:
Joel Barth Shapiro,	:
Walter William Anthony Boden, III,	:
Donald David Zell, Jr.,	:
and Gordon Jones II,	:
Respondents.	:

NOTICE OF FILING

On May 27, 2015, the Commission ordered the Division of Enforcement ("Division") to file and serve on Respondents by June 4, 2015, an affidavit and any supporting materials "setting forth the manner in which administrative law judge ("ALJ") Cameron Elliot and Chief ALJ Brenda Murray were hired, including the method of selection and appointment." The Division hereby submits the attached Affidavit, which contains the factual information the Division believes legally relevant to resolving Respondents' Article II-based constitutional claims—namely that, consistent with his status as an agency employee and not a constitutional officer, ALJ Elliot was not hired through a

process involving the approval of the individual members of the Commission.[1]

The Division also submits the following background information regarding the selection and hiring of Commission ALJs: Pursuant to current statutes and regulations, the hiring process for Commission ALJs is overseen by the U.S. Office of Personnel Management ("OPM"), which administers the competitive examination for selecting all ALJs across the federal government. *See* 5 U.S.C. §§ 1104, 1302; 5 C.F.R. § 930.201(d)-(e). As do other agencies, the Commission hires its ALJs through this OPM process. *See* 5 U.S.C. § 3105; 5 C.F.R. § 930.201(f). When the Commission seeks to hire a new ALJ, Chief ALJ Murray obtains from OPM a list of eligible candidates; a selection is made from the top three candidates on that list. *See* 5 U.S.C. §§ 3317, 3318; 5 C.F.R. §§ 332.402, 332.404, 930.204(a). Chief ALJ Murray and an interview committee then make a preliminary selection from among the available candidates. Their recommendation is

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[1] Respondents' contention that ALJ Elliot's hiring violated the Appointments Clause rests on the false premise that he is an inferior constitutional officer. As the Division has explained (Memorandum of Law in Response to the Commission's Order Requesting Supplemental Briefing at 4-13), ALJ Elliot is an employee, not an inferior officer. To the extent the Commission disagrees with the Division on this point, the Division believes that the facts set forth in the affidavit—*i.e.*, facts relating to ALJ Elliot's hiring—are sufficient for the Commission's consideration of Respondents' Appointments Clause challenge. Further, the Division notes that it was limited in its ability to collect information regarding ALJ hiring in light of *ex parte* considerations related to pending litigation.

subject to final approval and processing by the Commission's Office of Human Resources.[2]

It is the Division's understanding that the above process was employed as to ALJ Elliot, who began work at the agency in 2011. As for earlier hires, it is likely the Commission employed a similar, if not identical, hiring process. But the Division acknowledges that it is possible that internal processes have shifted over time with changing laws and circumstances, and thus the hiring process may have been somewhat different with respect to previously hired ALJs. For instance, Chief ALJ Murray began work at the agency in 1988 and information regarding hiring practices at that time is not readily accessible.

This 4th day of June, 2015

Respectfully submitted,

/s/ M. Graham Loomis

M. Graham Loomis
Robert K. Gordon
Anthony J. Winter
Attorneys for Division of Enforcement
Securities and Exchange Commission
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* * *

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[2] OPM retains oversight over each agency's "decisions concerning the appointment, pay, and tenure" of ALJs, 5 C.F.R. § 930.201(e)(2), and establishes classification and qualification standards for ALJ positions, *id.* § 930.201(e)(3). ALJs also are paid according to a statutorily prescribed pay schedule. 5 U.S.C. § 5372; 5 C.F.R. §§ 930.205, 206; *see also* http://www.opm.gov/policy-data-oversight/pay-leave/pay-administration/fact-sheets/administrative-law-judge-pay-system/ (ALJ pay system).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-15519

In the Matter of	:
	:
Timbervest, LLC,	:
Joel Barth Shapiro,	:
Walter William Anthony Boden, III,	:
Donald David Zell, Jr.,	:
and Gordon Jones II,	:
	:
Respondents.	:

AFFIDAVIT OF JAYNE L. SEIDMAN

Jayne L. Seidman, states that:

1. I am a Senior Officer at the Commission and Deputy Chief Operating Officer.

2. I make this Affidavit in response to the Commission's May 27, 2015, Order Requesting Additional Submissions and Additional Briefing.

3. In its May 27, 2015, Order, the Commission directed the Division to file and serve on Respondents by June 4, 2015, an affidavit and any supporting materials "setting forth the manner in which ALJ Cameron Elliot and Chief ALJ Brenda Murray were hired, including the method of selection and appointment."

4. Based on my knowledge of the Commission's ALJ hiring process, ALJ Elliot was not hired through

a process involving the approval of the individual members of the Commission.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on 4th day of June, 2015.

s/
Jayne L. Seidman
Deputy Chief Operating Officer

APPENDIX J

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

Pursuant to Circuit Rule 28, Petitioners Raymond J. Lucia Companies, Inc., and Raymond J. Lucia (collectively, "petitioners"), respectfully submit this Certificate as to Parties, Rulings, and Related Cases:

* * *

C. Related Cases

This matter has not previously been before this Court. Counsel for petitioners are not aware of any related cases currently pending in this Court or in any other court within the meaning of Circuit Rule 28(a)(1)(C).

Counsel for petitioners note, however, that the constitutionality of the method of appointment of the Commission's Administrative Law Judges has been raised in a number of other active proceedings in courts around the country, including the following:

- *Tilton v. SEC*, No. 16-906 (S. Ct.)
- *Timbervest, LLC v. SEC*, No. 15-1416 (D.C. Cir.)
- *Riad v. SEC*, No. 16-1275 (D.C. Cir.)
- *Bennett v. SEC*, No. 16-3827 (8th Cir.)
- *Aesoph v. SEC*, No. 16-3830 (8th Cir.) (consolidated with *Bennett*, No. 16- 3827, *supra*)
- *Feathers v. SEC*, No. 15-70102 (9th Cir.)
- *J.S. Oliver Capital Management v. SEC*, No. 16-72703 (9th Cir.)

- *Bandimere v. SEC*, No. 19-9586 (10th Cir.)
- *Imperato v. SEC*, No. 15-11574 (11th Cir.)
- *RD Legal Capital LLC v. SEC*, No. 16-5104 (D.N.J.)

In addition, the following proceedings open before the Commission according to its website were previously identified by either petitioners or the Commission as involving the same constitutional issue:

- *In the Matter of Laurie Bebo & John Buono, CPA*, File No. 3-16293
- *In the Matter of Bennett Group Financial Services, LLC & Dawn J. Bennett*, File No. 3-16801
- *In the Matter of Gregory T. Bolan, Jr.*, File No. 3-16178
- *In the Matter of Frank H. Chiappone, et al.*, File No. 3-15514
- *In the Matter of Edward M. Daspin, et al.*, File No. 3-16509
- *In the Matter of Gilles T. De Charsonville*, File No. 3-16712
- *In the Matter of Barbara Duka*, File No. 3-16349
- *In the Matter of Equity Trust Company*, File No. 3-16594
- *In the Matter of Gray Financial Group, Inc., et al.*, File No. 3-16554
- *In the Matter of Harding Advisory LLC & Wing F. Chau*, File No. 3-15574
- *In the Matter of Charles L. Hill, Jr.*, File No. 3-16383
- *In the Matter of Ironridge Global Partners, LLC & Ironridge Global IV, Ltd.*, File No. 3-16649

- *In the Matter of John Thomas Capital Management Group LLC d/b/a Patriot28, & George R. Jarkesy, Jr.*, File No. 3-15255
- *In the Matter of J.S. Oliver Capital Management, L.P., & Ian O. Mausner*, File No. 3-15446
- *In the Matter of Lawrence M. Labine*, File No. 3-15967
- *In the Matter of Paul Edward "Ed" Lloyd, Jr., CPA*, File No. 3-16182
- *In the Matter of Natural Blue Resources, Inc., et al.*, File No. 3-15974
- *In the Matter of Gordon Brent Pierce*, File No. 3-13109
- *In the Matter of Spring Hill Capital Markets, LLC*, File No. 3-16353
- *In the Matter of Lynn Tilton, et al.*, File No. 3-16462

APPENDIX K

CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

* * *

C. Related Cases

The case on review has not previously been before this, or any other, Court. Counsel is not aware of any related cases currently pending in this, or any other, Court.

As the Commission previously noted in its letter to the Court dated November 12, 2015 (Doc. No. 1583354), however, and as petitioners note in their brief, a number of other active cases and proceedings involve Appointments Clause challenges to the Commission's use of administrative law judges. In addition to the cases previously listed by the parties, the Commission is aware of the following pending cases that also involve an Appointments Clause challenge to the Commission's use of administrative law judges:[1]

Jacob Keith Cooper v. SEC, No. 15-73193 (9th. Cir.)

Harding Advisory LLC, et al. v. SEC, No. 17-1070 (D.C. Cir.)

Thomas C. Gonnella v. SEC, No. 16-3433 (2d Cir.)

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[1] By listing these cases, the Commission does not acknowledge that the challenges contained therein or in the cases listed by petitioners have been properly presented or preserved.

Malouf v. SEC, No. 16-9546 (10th Cir.)

The Robare Group, LTD., et al. v. SEC, No. 16-1453 (D.C. Cir.)

Bernerd E. Young v. SEC, No. 16-1149 (D.C. Cir.)

Alexander Kon, No. 3-17674 (SEC) & No. 17-3066 (10th Cir.)

* * *

Augustine Capital Management LLC, et al., No. 3-17740 (SEC)

Laurence I. Balter, No. 3-17614 (SEC)

Robert L. Baker, et al., No. 3-17716 (SEC)

Adrian D. Beamish, CPA, No. 3-17651 (SEC)

Bioelectronics Corp. et al., No. 3-17104 (SEC)

Michael W. Crow et al., No. 3-16318 (SEC)

Christopher M. Gibson, No. 3-17184 (SEC)

Donald F. Lathen, Jr., No. 3-17387 (SEC)

RD Legal Capital, LLC & Roni Dersovitz, No. 3-17342 (SEC)

Gary Snisky, No. 3-17645 (SEC)

Paul Leon White II, No. 3-17210 (SEC)